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# TERMINATION OF INTER VIVOS TRUSTS UNDER STATE LAW AND THE INTERNAL REVENUE CODE SECTION 2038

LEO W. LEARY\*

Generally speaking, under certain circumstances state law permits "premature" termination of an inter vivos trust<sup>1</sup> by a settlor acting alone, by a trustee acting alone, and by a settlor acting in conjunction with the beneficiaries of the trust. The main purpose of this article is to explore the inter-relationship of these three methods of trust termination under state law and the federal estate tax provision requiring inclusion in a deceased settlor's gross estate of any property interest transferred during lifetime "... where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power ... by the decedent alone or by the decedent in conjunction with any other person ... to alter, amend, revoke, or terminate. ..."<sup>2</sup>

## I. TERMINATION BY A SETTLOR ACTING ALONE

### A. *Power of Revocation*

Where the settlor has expressly reserved a power of revocation in the trust instrument, this is recognized, of course, under state law as a valid method of terminating a trust<sup>3</sup> and it was held at an early date that the assets of such a trust are includible in the settlor's gross estate since such a transfer is incomplete until his death extinguishes the power of revocation.<sup>4</sup>

Since section 2038 hinges taxability on the settlor having a power to revoke "... at the time of his death ...,"<sup>5</sup> in a number of cases it has

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<sup>1</sup> *I.e.*, prior to the time specified in the trust instrument.

<sup>2</sup> INT. REV. CODE OF 1954, §2038 (a) (1). The legislative history of §2038 and its predecessors is traced in MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §25.01 (1959), and in PAUL, FEDERAL ESTATE AND GIFT TAXATION §7.06 (1942, Supp. 1946).

No attempt will be made to determine whether the methods of trust termination discussed in this paper come within the ambit of §2036 (a) (2). On the relationship of the latter to §2038, see LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES §9.14 (2d ed. 1962).

<sup>3</sup> RESTATEMENT (SECOND), TRUSTS §330 (1) (1959). Unless the settlor lacks the requisite mental capacity at the time he attempts to exercise the power. *Kemmerer v. Kemmerer*, 74 Ohio Abs. 65, 139 N.E. 2d 84 (Ohio App. 1956).

<sup>4</sup> *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929). This reasoning was used to dispose of the constitutional issue of retroactivity raised in the case, the trusts having been created prior to the adoption of the federal estate tax in 1916.

<sup>5</sup> Unless the power has been relinquished in contemplation of death. On this alternative ground for inclusion in the gross estate, see LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES §9.12 (2d ed. 1962) and MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §13.11 (1959).

been argued that this requirement is lacking. But if a settlor creates a revocable trust, subsequently becomes incompetent, and a guardian of his property is appointed, the trust assets are includible in the settlor's gross estate when he dies on the theory that the power to revoke was in existence at his death even though he lacked capacity to exercise it.<sup>6</sup>

If a settlor inserts in the trust instrument restrictions on his exercise of a power to revoke, should this preclude inclusion of the trust assets in his gross estate if he dies while the restrictions are still in effect? In an early case a trust was created in 1923 and was expressly made irrevocable

... during and throughout the calendar year 1924 and ... during and throughout each calendar year thereafter, unless between the 1st and 31st days of December in 1924 or any subsequent year the same shall by the Trustor, by written notice to the Trustee, be revoked, such revocation to be effective on and after the first day of January next succeeding. ...<sup>7</sup>

The settlor having died January 5, 1926 without serving any notice of revocation, it was contended "... that when the year 1926 was once commenced, the trust to all intents and purposes became irrevocable for that year, and when the decedent died on January 5, 1926 he was without any power of revocation."<sup>8</sup> But the Board of Tax Appeals relied on the reasoning of *Chase National Bank v. United States*,<sup>9</sup> involving the constitutionality of including insurance proceeds in the gross estate of an insured who had retained incidents of ownership until his death. In answer to the argument that the insurance proceeds were transferred to the beneficiaries by the insurance company rather than by the insured, the Supreme Court observed:

... we think the power to tax the privilege of transfer at death cannot be controlled by the mere choice of the formalities which may attend the donor's bestowal of benefits on another at death, or of the particular methods by which his purpose is effected, so long as he retains control over these benefits with power to direct their future enjoyment until his death. Termination of the power to control at the time of death inures to the benefit of him

<sup>6</sup> See *Estate of Charles S. Inman*, 18 T.C. 522 (1952), *rev'd and remanded on another issue*, 203 F. 2d 679 (2d Cir. 1953). The Tax Court may have considered the possibility of the guardian applying to a state court for an order consenting to the termination of the trust since it referred to a state court's jurisdiction over the property of an incompetent and to *City Bank Farmers Trust Co. v. McGowan*, 323 U.S. 594 (1944), where a court-authorized transfer of assets owned by an incompetent person to her natural heirs was held to be a transfer in contemplation of death. As to whether, with court authorization, the guardian of an incompetent settlor can exercise a power to revoke under state law, see NOSSAMAN, *TRUST ADMINISTRATION AND TAXATION* §21.16 (rev. ed. 1961); BOGERT, *TRUSTS AND TRUSTEES* §1000, at 491-492 (2d ed. 1962); SCOTT, *TRUSTS* §58.4n.9 (2d ed. 1956). Cf. *Estate of Edward L. Hurd*, 6 T.C. 819, *aff'd*, 160 F. 2d 610 (1st Cir. 1947), discussed in note 184 *infra*.

<sup>7</sup> *Katherine B. Albrecht*, 27 B.T.A. 1091, 1092 (1933).

<sup>8</sup> *Id.* at 1094.

<sup>9</sup> 278 U.S. 327 (1929).

who owns the property subject to the power and thus brings about, at death, the completion of the shifting of the economic benefits of property, which is the real subject of the tax, just as effectively as would its exercise. . . .<sup>10</sup>

Since the settlor could have revoked the trust if he had lived through 1926 and into 1927, by revoking in December of 1926 with the revocation becoming effective January 1, 1927, the Board considered the settlor's death in 1926 as the event which cut off the power to revoke. "This constituted a shifting of economic benefits with respect to the trust fund and in our opinion constituted a transfer at death which was the appropriate subject of the estate tax."<sup>11</sup>

Meanwhile, Congress was apparently concerned as to the possibility of formal restrictions on the exercise of a power to revoke being used as a means of escaping estate taxation when the settlor died, so the Revenue Act of 1934 provided that a power to revoke was to be considered as existing at the settlor's death

. . . even though the exercise of the power is subject to a precedent giving of notice or even though the . . . revocation . . . takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such purpose, if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.<sup>12</sup>

The legislative history shows that although Congress was of the opinion that arguments for exclusion of trust assets from a gross estate because of such restrictions ". . . would not be well founded, your committee believes it desirable to clarify the law so that under such circumstances it will be entirely clear that all the property of which decedent at the date of his death has to all intents and purposes practical, if not technical ownership, is to be included in his gross estate."<sup>13</sup> But detailed statu-

<sup>10</sup> *Id.* at 338.

<sup>11</sup> Katherine B. Albrecht, *supra* note 7, at 1095. The Treasury, citing the *Albrecht* decision, ruled that a settlor, who had amended the trust instrument in 1927 to provide that it could not be revoked until 1930 and who died in 1929, had a taxable power at the date of her death. G.C.M. 11034, XII-2 CUM. BULL. 270 (1933).

The *Albrecht* case was followed as to comparable restrictions on exercise in *Fidelity-Philadelphia Trust Co.*, 34 B.T.A. 614 (1936), discussed in note 45 *infra*.

<sup>12</sup> REVENUE ACT OF 1934, §401, 48 Stat. 752 (1934). This provision is now §2038 (b).

<sup>13</sup> H.R. Rep. No. 704, 73rd Cong., 1st Sess. (1934), 1939-1 CUM. BULL., pt. 2, 261. See also Sen. Rep. No. 558, 73rd Cong., 2d Sess., 1939 1 CUM. BULL., pt. 2, 620. The emphasis on an ownership test has been aptly characterized as a ". . . then current inadequate appreciation by Congress of the scope of this pro-

tory treatment of certain restrictions on the exercise of a power of revocation left open the question as to the tax effect of other types.<sup>14</sup>

There was no express reference to the 1934 amendment in a 1936 Board of Tax Appeals decision, possibly because it was decided under the Revenue Act of 1926. There the decedent had created a trust for the support of his daughter during her minority, upon the daughter's reaching 21 she was to receive the net income for life, and on her death the corpus was to pass as she appointed by will, in default of appointment to her then living descendants. The decedent had reserved a "... power to revoke, with the concurrence and assent of the said Margaret Dunning Day after she shall have attained majority. . . ." Decedent having died when the daughter was 15 years of age, it was contended "... that the decedent had no power to revoke at the time of his death in 1931, since at that time his daughter had not reached her majority and the power to revoke would not spring into being until she could concur in its exercise."<sup>15</sup> Here the Board did not rely on reasoning comparable to that used in the *Albrecht* case,<sup>16</sup> i.e. that had the decedent lived until his daughter attained her majority he could have revoked the trust with her consent so that his death terminated the power. This may have been because the Board considered a "shifting of economic benefits" test inappropriate here where the daughter would have had to consent to any revocation and her testamentary power of appointment prevented any indefeasible vesting in others as of decedent's death. But the Board used a "cessation of substantial control" test to include in this decedent's gross estate two other trusts set up for two adult sons which could only be revoked with their consent.<sup>17</sup> Instead of applying the same test to the daughter's trust on the assumption that the power to revoke could not be exercised until the daughter reached the age of 21, the Board felt compelled to construe the trust instrument as giving the decedent a power to revoke alone while the daughter was still a minor before including the assets of this trust in the decedent's gross

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vision." MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION, §25.01 n.12 (1959).

<sup>14</sup> Awareness of problems created by the 1934 amendment was shown in a bill introduced in the next Congress. The accompanying House Report stated: "At the present time, section 302 (d) (2) expressly provides that a power shall be deemed to exist on the date of decedent's death even though the exercise of the power is subject to a precedent giving of notice. Express language is added that the same result would be obtained, even though the exercise of the power is restricted to a particular time or the happening of a particular event which had not arrived or occurred at the decedent's death. This is a clarifying amendment and it is believed to be declaratory of existing law." H.R. Rep. No. 2818, 7th Cong., 2d Sess., 9-10 quoted in PAUL, FEDERAL ESTATE AND GIFT TAXATION §7.06, at 301 n. 18 (1942). This bill was not adopted. MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §25.01 n.4 (1959).

<sup>15</sup> Margaret Day, 34 B.T.A. 11, 20 (1936).

<sup>16</sup> See text preceding note 11 *supra*.

<sup>17</sup> Margaret Day, *supra* note 15, at 19. Here the Board followed *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935).

estate.<sup>18</sup> On appeal, the decision was reversed in summary fashion. "After argument and consideration, we are of opinion that up to the time of the creator's death, which occurred during his daughter's minority, he had no present power to alter, amend, or revoke, . . ."<sup>19</sup>

Where a decedent had retained a power to revoke ". . . in the event I should marry . . .," and died without having married, the Board exhibited some dissatisfaction with a test based on whether the power was presently existing or conditioned upon a future event.<sup>20</sup> But no attempt was made to determine whether this particular event was at least somewhat within the control of the decedent during his lifetime or whether the power might be considered in existence at his death and at most subject to defeasance on a condition subsequent. Instead, it found that the power gave the settlor a possibility of getting the property back and, hence, was a transfer intended to take effect at or after death within the rationale of *Helvering v. Hallock*.<sup>21</sup>

In *Estate of Edward Lathrop Ballard*<sup>22</sup> a decedent, after setting up a trust under which he reserved a power to alter, amend, and revoke, executed an amendment wherein he granted a power to revoke to his wife, revoked his own power to alter, amend, and revoke during the lifetime of his wife, and was to regain this power only at her death.<sup>23</sup> The decedent having predeceased his wife, the Board held the decedent had no present power to revoke the trust at the time of his death and the fact that he had a "contingent" power to revoke did not cause inclusion of the trust property in his gross estate.<sup>24</sup>

<sup>18</sup> Margaret Day, *supra* note 15.

<sup>19</sup> Day v. Comm'r, 92 F. 2d 179, 180 (3rd Cir. 1937).

<sup>20</sup> Estate of Homer G. Day, 41 B.T.A. 580 (1940).

<sup>21</sup> 309 U.S. 106 (1940). Curiously, the *Hallock* decision failed to cause any reexamination of whether a settlor with a restricted power of revocation had at his death a sufficient "hold" on the trust assets to require their inclusion under the predecessors of §2038, despite approval in the *Hallock* case of the dissenting opinion in *Helvering v. St. Louis Trust Co.*, 296 U.S. 39, 46-47 (1935), until nine years after the decision. By this time the Tax Court considered the law too firmly established by prior decisions to be reexamined. But it did state that *Hallock*, Comm'r v. Estate of Church, 335 U.S. 632 (1949), and *Estate of Spiegel v. Comm'r*, 335 U.S. 701 (1949), dealt with statutory language significantly broader than the "at date of his death" phrase in the predecessors of §2038, such phrase having been only partially modified by the 1934 amendment. *Estate of Cyrus C. Yawkey*, 12 T.C. 1164, 1170-1172 (1949).

<sup>22</sup> 47 B.T.A. 784 (1942), *aff'd per curiam*, 138 F. 2d 512 (2d Cir. 1943).

<sup>23</sup> This elaborate procedure was used presumably to avoid any question of an attempted assignment of his original power of revocation to his wife since this would have raised the question of whether a power of revocation is personal and, hence, not assignable under state law. See *Grove v. Payne*, 47 Wash. 2d 461, 288 P. 2d 242 (1955).

<sup>24</sup> In support of the last proposition, the Board cited *Tait v. Safe Deposit & Trust Co. of Baltimore*, 74 F. 2d 851 (4th Cir. 1935), involving a reserved power to amend the trust, except as to the interest of decedent's wife during her lifetime. There the government contended decedent, who predeceased his wife, had a contingent power to change even the wife's interest if she predeceased him. The court held: "A sufficient answer to the government's contention is furnished by the language of the statute itself, when considered

The Treasury has finally conceded that "... section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during decedent's life)."<sup>25</sup>

A second requirement for taxability under section 2038 is that the settlor has made an inter vivos transfer of an interest "... where the enjoyment thereof was subject ... to any change through the exercise of a power ... to revoke, ... ." "When Congress has directed that tax consequences turn on the existence or nonexistence of a primary legal obligation such as a power or a duty, reference to state law seems mandatory."<sup>26</sup> According to the Hohfeldian terminology adopted by the American Law Institute, a power "... is an ability on the part of a person to produce a change in a given legal relation by doing or not doing a given act."<sup>27</sup> A person with such a power may also have a privilege<sup>28</sup> which is defined as "... a legal freedom on the part of one person against another to do a given act or a legal freedom not to do a given act."<sup>29</sup> A power reserved by the settlor of a trust may be held solely for his own benefit, in which case its exercise or nonexercise is not subject to judicial supervision, or the power may be held for the benefit of others, in which case its exercise or nonexercise is subject to judicial supervision.<sup>30</sup> If the power mentioned in section 2038 was intended by Congress to encompass the mere ability to change the enjoyment of beneficial interests under a trust,<sup>31</sup> unless a state court can prevent this from occurring, such an ability should be within the ambit of this section. No difficulty would arise under this approach where a settlor has expressly reserved a power to revoke, since this should be classified under state law as a power held solely for the settlor's benefit and not subject to court control.<sup>32</sup> Equivalent tax treatment should result where the settlor has retained a power to withdraw trust assets for his own benefit.<sup>33</sup> But where the reserved power is merely to control

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together with the fact that the contingent power expired with the grantor's death. The wife survived, and the power never ripened into an actuality, was never a power which the grantor could have exercised with effect, and it may not, therefore, be said that the enjoyment of this portion of the trust property was 'subject at his death to any change through the exercise of a power ... to alter, amend or revoke.'" *Id.* at 858.

<sup>25</sup> Treas. Reg. §20.2038-1 (b).

<sup>26</sup> Note, 72 HARV. L. REV. 1350, 1352 (1959). See note 59 *infra*.

<sup>27</sup> RESTATEMENT, PROPERTY §3 (1936).

<sup>28</sup> *Id.*, comment a, illustration 2.

<sup>29</sup> Note 27 *supra*, §2. Here the other person has no right that the act shall or shall not be done. *Id.*, comment a.

<sup>30</sup> On the state law distinction between the two types of powers, see RESTATEMENT (SECOND), TRUSTS §185 (1959), and SCOTT, TRUSTS §185 (2d ed. 1956).

<sup>31</sup> See note 60 *infra*.

<sup>32</sup> See *Clarke v. United States*, 180 F. Supp. 696 (N.D. Me. 1960).

<sup>33</sup> See *Commonwealth Trust Co. of Pittsburgh v. Driscoll*, 50 F. Supp. 949 (W. D. Penn. 1943), *aff'd per curiam*, 137 F. 2d 653 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1944), where the settlor reserved "... the right to make any substitutions of securities from time to time as he deemed ad-

investments made by the trustee, this could be considered a fiduciary power which is subject to court control so that it could not be exercised in a way which would enable the settlor to recapture the trust assets.<sup>34</sup> It may be quite unlikely that when the trust beneficiaries are members of the settlor's family they would attempt to block the settlor's action by judicial proceedings<sup>35</sup> and a trustee may be willing to rely on an exculpatory clause applicable when the trustee follows the settlor's directions.<sup>36</sup> However, it is questionable whether the application of section 2308 should depend on a weighing of such possibilities.<sup>37</sup>

In defining a power of appointment, the American Law Institute distinguished a power of revocation.<sup>38</sup> While recognizing the similarity of the latter to a general power of appointment presently exercisable, it was felt that "... powers of revocation are not powers of appointment by the common usage of the profession and the characteristic problems discussed in this Chapter do not arise with reference to them."<sup>39</sup> For purposes of section 2038, even a general testamentary power of appointment reserved by a settlor has been considered the equivalent of a power to revoke.<sup>40</sup> Since the settlor can appoint to his

visible." This was held to be subject to the predecessor of §2038, the court refusing to find that the settlor was under a duty to substitute securities equal in value to those withdrawn.

<sup>34</sup> See *Estate of Henry S. Downe*, 2 T.C. 967, 972 (1943), where the settlor reserved "... the option to direct in writing the Trustee to issue voting proxies on and to retain, sell, exchange, invest and reinvest any of the trust property held hereunder in such manner as he may direct and without liability to the Trustee for resulting loss; . . ." Such a reservation was held not equivalent to a power of withdrawal, relying on income tax cases involving the predecessor of §676. Section 675 now attributes trust income to the settlor for income tax purposes only if he has a power to control investments exercisable in a nonfiduciary capacity without the approval or consent of any person acting in a fiduciary capacity.

<sup>35</sup> In *Carrier v. Carrier*, 226 N.Y. 114, 123 N.E. 135, 858 (1919), a wife obtained an injunction against a husband loaning trust assets to himself, but the proceedings occurred after the husband had deserted the wife and at the same time that the latter started proceedings for a legal separation.

<sup>36</sup> See *Reeve v. Chase National Bank*, 247 App. Div. 515, 287 N.Y.S. 937 (1936); *CRONIN, Effectiveness of Exculpatory Clauses in Directing Trusts*, 98 TRUSTS AND ESTATES 1147 (1959).

<sup>37</sup> *But cf.* Treas. Reg. §1.675-1 (b) (4): "If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." (Emphasis added.)

<sup>38</sup> RESTATEMENT, PROPERTY §318 (1940).

<sup>39</sup> *Id.*, comment i.

<sup>40</sup> *Bank of New York & Trust Co., Executor*, 21 B.T.A. 197 (1930); *Day Kimball*, 29 B.T.A. 60 (1933). The American Law Institute defines a power to revoke as a power exercisable only in favor of the settlor. Note 39 *supra*. The Board of Tax Appeals in the cited cases was not concerned with the inability of the settlor to make any changes during lifetime but with the incompleteness of the interests given the trust beneficiaries since, as takers in default of appointment, their interests were subject to divestment by the settlor appointing to someone else. Under state law it has been held that where no method of revocation is specified in the trust instrument, an existing trust can be revoked by executing a new trust instrument without first formally revoking the prior trust. *Lambdin v. Dantzebecker*, 169 Md. 240, 181 Atl. 353, 102 A.L.R. 277 (1935).



own estate, this might properly be considered a power held for the sole benefit of the settlor rather than in a fiduciary capacity under the state law of trusts.<sup>41</sup> Under state law on powers of appointment, a general testamentary power can be released during the lifetime of the donee,<sup>42</sup> which indicates it is not considered a power held in a fiduciary capacity. The conflicting rule barring a donee from contracting during his lifetime to exercise or refrain from exercising the power<sup>43</sup> is not based on the fiduciary nature of the power but rather on the donor's intent that the donee be free to exercise the power at his death.<sup>44</sup> In any event, a settlor reserving a general testamentary power could not be restrained by a court from appointing to his estate.<sup>45</sup>

If a settlor has not expressly reserved a power of revocation as such, an intent to reserve such a power may be implied from other language in the trust instrument<sup>46</sup> and, where the latter is ambiguous, extrinsic evidence is admissible to show the settlor's intent.<sup>47</sup> Since an implied power of revocation results in the inclusion of the trust assets in a deceased settlor's estate,<sup>48</sup> the American Law Institute suggests that in certain situations tax consequences may be an important factor for judicial consideration in determining whether a settlor intended to reserve a power of revocation.<sup>49</sup>

Absent the reservation of an express or implied power of revocation, under the majority state law view a settlor acting alone cannot revoke a trust.<sup>50</sup> But where the trust instrument is silent on the matter,

<sup>41</sup> See citations in note 30 *supra*.

<sup>42</sup> RESTATEMENT, PROPERTY §334, comment *a* (1940).

<sup>43</sup> *Id.* §340.

<sup>44</sup> *Id.*, comment *a*. It is questionable whether this rule should be applied where the donee is also the donor of the power.

<sup>45</sup> The restrictions on appointment, as to permissible appointees and the type of interest which may be given them, apply only where the donee has a special power. *Id.* §§350-361.

Formal restrictions on the exercise of a general testamentary power inserted in the trust instrument have been disregarded for tax purposes. *Fidelity-Philadelphia Trust Co.*, *supra* note 11, where the power had to be exercised by a will made at least thirty days before death.

<sup>46</sup> In *Trenton Banking Company v. Howard*, 121 N.J. Eq. 85, 187 Atl. 569 (1936), *aff'd*, 121 N.J. Eq. 85, 187 Atl. 575 (1936), the instrument provided: "The grantor reserves the right to add to or decrease said fund from time to time as she may desire." This was held to amount to a general power to revoke.

<sup>47</sup> Where the instrument gave the trustees certain specified powers "unless otherwise directed," parol evidence was admitted to show the settlor intended to reserve a power to revoke. *Lambdin v. Dantzbecker*, *supra* note 40.

<sup>48</sup> *Estate of Michael A. Doyle*, 32 T.C. 1209 (1959), involving a savings account in the name of the decedent as trustee for another.

<sup>49</sup> RESTATEMENT (SECOND), TRUSTS §330, comment *c* (1959). See *Frensley v. Phinney*, 3 A.F.T.R. 2d 1857, 59-1 U.S.T.C. ¶11876 (W.D. Tex. 1959), discussed in note 96 *infra*.

<sup>50</sup> RESTATEMENT (SECOND), TRUSTS §330 (1959). If the settlor intended to reserve a power of revocation but by mistake failed to insert such a provision in the trust instrument, he is entitled to reformation and can then revoke the trust. *Id.* §332(1). Reformation or rescission of a trust is also available to the extent that its creation was due to fraud, undue influence, mistake and the like. *Id.*

Rhode Island by court decision in a pre-estate tax era<sup>51</sup> and California,<sup>52</sup> Oklahoma<sup>53</sup> and Texas<sup>54</sup> by statute grant the settlor a power of revocation. Despite the assumptions of others,<sup>55</sup> it has been vigorously contended that such state law deviations should be disregarded in the application of section 2038 because of the desirability of a uniform application of a nationwide tax statute.<sup>56</sup> But it would seem that uniformity in application should mean "... *fiscal justice in federal tax administration* . . ." and this "... calls for substantially equivalent tax

§333. An early article raised the question of whether a power to rescind a transfer for fraud was subject to the predecessor of §2038. Surrey & Arenson, *Inter Vivos Transfers and the Federal Estate Tax*, 32 COL. L. REV. 1332, 1334, 1354 n.99 (1932). It has been suggested that such a power is excludible as a condition imposed by law. See Cappa, *infra* note 56, at 158.

<sup>51</sup> Aylsworth v. Whitcomb, 12 R.I. 298 (1879), held that failure to reserve a power of revocation raised a presumption that it had been omitted by mistake. The presumption is rebutted where the trust instrument is expressly stated to be irrevocable or otherwise show a contrary intent. Neisler v. Pearsall, 22 R.I. 367, 48 Atl. 8 (1901); Wallace v. Industrial Trust Co., 29 R.I. 550, 73 Atl. 25 (1909).

<sup>52</sup> CAL. CIV. CODE, §2280, as amended by CAL. STATS. 1931, at 1955. Non-tax reasons appear to have prompted adoption of the statute. "This change was apparently made for the reason that many trustors were not aware that they were creating irrevocable trusts and were unable to revoke them when their circumstances became such that they needed the trust corpus themselves. Also, in many cases the income from the trusts became inadequate to support the trustors, who found themselves precluded from reaching the trust corpus. These hardships on unsuspecting trustors became especially acute because of the drastic changes in the general financial situation caused by the economic upheavals of 1929 and 1930." Comment, 28 CALIF. L. REV. 202, 208 (1940).

The tax implications of such a statute, however, have raised questions as to its present desirability. "It would seem desirable to reconsider §2280 in the light of the present INTERNAL REVENUE CODE. By the section cited, all voluntary trusts are revocable unless they are expressly declared to be irrevocable in the instrument of trust. I have never understood why trustors should be presumed to be 'Indian givers' any more than other grantors, and I believe many a trustor has not supposed he retained powers of revocation in which the declaration of trust made no reference. Yet that unsuspected power could cost his heirs dearly through increased estate taxes." Evans, "Observations on the State of the California Laws of Uses and Trusts," 28 So. CALIF. L. REV. 111, 120 (1955).

<sup>53</sup> 60 OKLA. STAT. ANN. §175.41, added by Okla. Laws of 1941, at 263.

<sup>54</sup> TEX. CIV. STAT. ANN., art. 7425b-41, added by TEX. ACTS OF 1943, ch. 148, §41. Seemingly, those active in the adoption of this statute were aware of both tax and non-tax consequences. "The Texas rule was adopted because, as numerous cases reveal, where creation of a trust has been improvident, extreme hardship has often resulted to a trustor and his family through the failure to reserve a power of revocation. Equally extreme hardships in the form of new and increased taxes are likely to result from the new rule. Retention of a power of revocation will cause the trust income to be taxed as part of the net income of the trustor, and, upon his death, the corpus of the trust will be included as part of his estate for tax purposes. . . . In these days when every trust attorney must keep at least one eye and both hands engaged with problems of taxation, failure to notice §41 and to insert an 'irrevocability clause' in a trust instrument may well prove catastrophic." Moorhead, *The Texas Trust Act*, 22 TEX. L. REV. 123, 132 (1944).

<sup>55</sup> Notes 52 and 54 *supra*.

<sup>56</sup> Cappa, *The Effect of Section 2280 of the California Civil Code on the Federal Estate Tax*, 15 So. CALIF. L. REV. 155, 158-163 (1942), relying primarily on Burnet v. Harmel, 287 U.S. 103 (1932), Lyeth v. Hoey, 305 U.S. 188 (1938), and United States v. Pelzer, 312 U.S. 399 (1941).

treatments for persons in substantially equivalent economic positions."<sup>57</sup> As previously pointed out,<sup>58</sup> section 2038 necessarily requires reference to state law for a determination of whether in fact a decedent had a power to revoke a trust he had created.<sup>59</sup> It is true, however, that a merely formal state law classification of a particular power as a power to revoke or as not a power to revoke should not control the application of section 2038 unless Congress so intended.<sup>60</sup> Hence, a formal state law classification of general and special powers of appointment was disregarded in the application of a predecessor of section 2041.<sup>61</sup> Is any state law distinction between a power of revocation reserved in the trust instrument and one granted by statute, unless the trust instrument manifests a contrary intent, also a mere formal distinction which should be disregarded in the application of a federal tax statute? Any such distinction has been disregarded in attributing trust income to the settlor of a trust for income tax purposes<sup>62</sup> and in determining whether a completed gift has been made for gift tax purposes.<sup>63</sup> Has Congress manifested any intent to limit section 2038 to a trust with an expressly reserved power of revocation and to exclude a trust where the settlor's power of revocation is granted by statute?

Although as a matter of policy both settlors have equivalent economic positions so that fiscal justice would seem to require equivalent tax treatment, it has been maintained that "... a statutorily imposed power of revocation . . . is a condition imposed by law and as such not within the contemplation of Section [2038], which appears to require the formal reservation of the power in the trust instrument."<sup>64</sup> This interpretation was based on *Helvering v. Helmholz*,<sup>65</sup> *White v. Poor*,<sup>66</sup> and a restrictive reading of the 1936 amendments to the predecessor of section 2038.<sup>67</sup>

*Helmholz* involved a trust to which stock in a close corporation was transferred by members of a family which included the decedent, each settlor reserving the right to the net dividend income for life from his respective stock contribution plus a testamentary power to appoint his

<sup>57</sup> Oliver, *The Nature of the Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF L. REV. 638, 640 (1953).

<sup>58</sup> Text preceding note 26 *supra*.

<sup>59</sup> The area of trust termination seems clearly within the maxim: "State law creates legal interests and rights." *Morgan v. Comm'r*, 309 U.S. 78, 80 (1940).

<sup>60</sup> "If it be found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law." *Id.* at 81.

<sup>61</sup> *Morgan v. Comm'r*, 309 U.S. 78 (1940).

<sup>62</sup> *George S. Gaylord*, 3 T.C. 281 (1944), *aff'd*, 153 F. 2d 408 (9th Cir. 1946); *Erik Krag*, 8 T.C. 1091 (1947).

<sup>63</sup> *Lois J. Newman*, 19 T.C. 708 (1953), *aff'd*, 222 F. 2d 131 (9th Cir. 1955).

<sup>64</sup> Cappa, *supra* note 56, at 155.

<sup>65</sup> 296 U.S. 93 (1935).

<sup>66</sup> 296 U.S. 98 (1935).

<sup>67</sup> REVENUE ACT OF 1936, §805, 49 STAT. 1744 (1936).

share of dividend income but not the corpus. The trust was to terminate upon the happening of certain events including

. . . delivery to the said trustee of a written instrument signed by all of the then beneficiaries, other than testamentary appointees, declaring said trust term at an end, . . . whereupon . . . the said trustee shall distribute the capital stock of said The Patrick Cudahy Family Company to the beneficiaries then entitled to receive the net dividends thereon other than testamentary appointees; excepting the shares to the dividends upon which such testamentary appointees are entitled, which shall be held by said trustee as hereinbefore provided.<sup>68</sup>

To the Commissioner's contention that this provision was equivalent to a power to revoke or amend by the settlor with others since the decedent and her co-beneficiaries while she was alive could have executed a writing which would effect a revesting in her of the shares she had transferred to the trustee, the court replied:

This argument overlooks the essential difference between a power to revoke, alter or amend, and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust.<sup>69</sup> The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor<sup>70</sup> a trust created in a state whose law permits all the beneficiaries to terminate the trust.<sup>71</sup>

Assuming the court was not merely concerned with the constitutional power of Congress to tax the trust involved in *Helmholz* and that the decision still has standing as precedent in the interpretation of section 2038,<sup>72</sup> then some methods of trust termination under state law are beyond the scope of this section. Considering the court's citations,<sup>73</sup> two of these are the rule that if all of the beneficiaries of a trust consent and none of them is under an incapacity, they can compel the termination of a trust except where its continuance is necessary to carry out a material purpose of the settlor in creating it<sup>74</sup> and the rule that if the

<sup>68</sup> Waldemar R. Helmholz, 28 B.T.A. 165, 166 (1933). A number of the trust provisions are set forth verbatim in *id.* at 165-166. The terms of the trust are summarized in *Helvering v. Helmholz*, 75 F. 2d 245-246 (D.C. Cir. 1934).

<sup>69</sup> Since the court was referred to no local Wisconsin law to the contrary, it cited RESTATEMENT, TRUSTS §§337, 338 (1935), in support of this statement.

<sup>70</sup> Although the court purported to be dealing with §302(d) of the REVENUE ACT OF 1926 which specifically dealt with powers to revoke, it may have used the language of §302(c) on the assumption that the former was merely a specific example of the latter or because of its alternative holding that applying §302(d) retroactively to a trust prior to its adoption would be unconstitutional.

<sup>71</sup> 296 U.S. 93, 97.

<sup>72</sup> See MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §§25.19-25.20 (1959).

<sup>73</sup> Note 69 *supra*.

<sup>74</sup> The court appears to have either been unaware of the exception or assumed it did not apply to a trust where the settlors expressly permitted termination by the beneficiaries. Unfortunately, the court did not inquire as to whether this rule requires not only the consent of current income beneficiaries but

settlor and all of the beneficiaries of a trust consent and none of them is under an incapacity, they can compel termination of the trust even if the original purpose of the settlor in creating the trust has not been accomplished.<sup>75</sup> Because of the court's cursory treatment of the state law of trusts,<sup>76</sup> it may have been under the impression that these two rules were "conditions which the law imposes" irrespective of the settlor's original intent and any provision he inserted in the trust instrument.<sup>77</sup> If so, these methods of trust termination are distinguishable from a state statute giving a settlor a power to revoke unless he manifests a contrary intent in the trust instrument.

In *Poor*<sup>78</sup> the decedent did not retain a power to revoke as settlor but instead named herself as one of three co-trustees and gave the trustees a power to terminate the trust and reconvey the property to the decedent. She subsequently resigned as trustee and, pursuant to a power to fill vacancies provided in the trust instrument, decedent's daughter was appointed as successor trustee. After serving for a year the daughter resigned, the decedent was appointed and served as trustee until her death. The court refused to accept the contention that the trust assets were includible in the decedent's gross estate under section 302(d) of the Revenue Act of 1926, stating:

Mrs. Sargent resigned as a trustee in 1920 and was succeeded by her daughter, one of the beneficiaries. When, a year later, the daughter resigned a new trustee could be appointed only by the written nomination of the two remaining trustees with the approval of all of the beneficiaries of the trust. By such concerted action Mrs. Sargent was again appointed trustee. She then acquired any power for the future to participate in a termination of the trust, solely by virtue of the action of the other trustees and the beneficiaries and not in any sense by virtue of any power

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also of successor income beneficiaries plus those with either a vested or contingent interest in corpus. See RESTATEMENT, TRUSTS §337, comment *b* (1935), referring to *id.* §340. If consent of the latter is required under state law, a provision requiring the consent of only current income beneficiaries would add rights not conferred by state law.

<sup>75</sup> It is difficult to see why the court referred to this rule in *Helmholz* unless it was to show recognition of the fact that the decedent was a settlor as well as a beneficiary. Had the court shown an awareness of the exception to the first rule and had some doubts as to whether termination by the beneficiaries would interfere with the original purpose of the settlors, it might have turned to the second rule which does not contain this exception. Also, had the court considered the consent of all beneficiaries necessary under the first rule, it might have taken some comfort from the fact that the second rule permits a partial termination if this does not prejudice the interest of non-consenting beneficiaries such as the testamentary appointees. RESTATEMENT, TRUSTS §338(2) (1935). However, the American Law Institute position is that otherwise even the consent of unascertained beneficiaries is required. *Id.*, comment *f*.

<sup>76</sup> See quotation from opinion in text at note 71 *supra*.

<sup>77</sup> Strictly speaking, the settlor can affect the application of these rules, as restated by the American Law Institute, by setting forth in the trust instrument the purposes he desires to have accomplished by the trust and by naming unascertained beneficiaries.

<sup>78</sup> Note 66 *supra*.

reserved to herself as settlor in the original declaration of trust. We think, therefore, that neither technically nor in substance does the power to terminate as it existed from 1921 to the date of Mrs. Sargent's death fall within Section 302(d).<sup>79</sup>

A year later Congress amended the statute to cover not only a power of revocation but also a power of termination.<sup>80</sup> Congress further provided that the statute applied to both powers "... (in whatever capacity exercisable) . . ." and "... (without regard to when or from what source the decedent acquires such power) . . ."<sup>81</sup> A House Committee Report stated:

The changes made by this section are made necessary largely by reason of the decision in the case of *White v. Poor*. . . . The case . . . suggested that section 302(d) may be circumvented in many ways so long as the power to alter, amend, revoke, or terminate does not accrue to the settlor by virtue of the reservation in the trust instrument. It is, therefore, provided that section 302(d) covers a power whether created at the time of transfer or thereafter arising from any source and whether exercisable in an individual or representative capacity. To some extent, it is believed this amendment is declaratory of existing law. To the extent that it is not so declaratory, it is prospective and will apply to transfers made after the date of enactment of this act.<sup>82</sup>

It has been suggested that some of the above language "... indicates an intent to cover only the situation of an original reservation in the trust instrument or the acquisition of a power subsequent to the declaration of trust."<sup>83</sup> But the Board of Tax Appeals, in holding a gift made in 1930 includible in the donor's gross estate because at all times the donor had a power of revocation granted by statute, referred to the above language and stated: "The legislators believed that the changes were to some extent declaratory of existing law. . . . We think they are purely declaratory so far as the issue here is concerned."<sup>84</sup> The Board did not refer to the fact that this House Report actually accompanied a bill which was not adopted, although part of it, with changes, was later included in the Revenue Act of 1936.<sup>85</sup> Hence, any attempt to limit the clear language of the 1936 amendments by this particular Report seems doomed, considering the unsuccessful attempt to use more

<sup>79</sup> 296 U.S. at 101-102.

<sup>80</sup> Note 67 *supra*. It had been urged in *Poor* that a power to terminate was not within §302(d) of the REVENUE ACT OF 1926 since the latter listed only a power to alter, amend or revoke. The court found it unnecessary to decide this issue. The Supreme Court subsequently held this amendment was merely declaratory of pre-existing law. *Comm'r v. Estate of Holmes*, 326 U.S. 480 (1946). See note 129 *infra*.

<sup>81</sup> Note 67 *supra*.

<sup>82</sup> H.R. Rep. No. 2818, 74th Cong., 2d Sess., quoted in PAUL, FEDERAL ESTATE AND GIFT TAXATION §706, at 301 n.18 (1942).

<sup>83</sup> Cappa, *supra* note 56 at 157 n.11.

<sup>84</sup> Estate of Felicie Gimbel Keiffer, *infra* note 90, at 1267-1268.

<sup>85</sup> MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §25.01 n.4 (1959).

immediately relevant legislative history to limit the scope of section 302 (d) as originally added by the Revenue Act of 1924.<sup>86</sup>

The assumption that a power of revocation granted by statute in California and Texas is subject to section 2038<sup>87</sup> seems to be shared by the Revenue Service even as to trusts created prior to the 1936 amendments.<sup>88</sup> The latter assumption is bolstered by decisions applying the pre-1936 tax statute to inter-spousal gifts made at a time when a Louisiana statute<sup>89</sup> made any such gifts revocable irrespective of the donor's intent.<sup>90</sup>

At one time a substantial majority of Board of Tax Appeal members considered a power of revocation imposed by law beyond the scope of the predecessor of section 2038 because of *Helmholz* and *Poor*. In *Dorothy A. D. Allen*<sup>91</sup> the taxpayer, while still a minor created a trust under which she retained no express or implied power of revocation under the terms of the instrument but under state law she had the power to avoid the transfer until a reasonable time after she became 21. The trust having been created shortly before the adoption of the federal gift tax statute, the issue was whether a completed gift had been made when the trust was created. In holding the gift complete when the trust was created a majority of the Board relied in part on *Helmholz* and *Poor*. The power of a minor to avoid a gift was considered a condition which the law imposes under *Helmholz* and *Poor* requiring reservation of the power to revoke in the trust instrument. Two dissenting judges distinguished *Helmholz*.

There the trust instrument provided that the grantor should be entitled to a return of the property transferred in trust provided all of the beneficiaries agreed in writing that he should have it back. In this case the infant grantor alone and without regard to the desires or wishes of the beneficiaries had the power to revest in herself the title to the property transferred.<sup>92</sup>

On appeal, the Third Circuit reversed,<sup>93</sup> *Helmholz* was distinguished by less satisfactory reasoning.

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<sup>86</sup> *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935).

<sup>87</sup> See notes 52 and 54 *supra*. A comparable assumption seems permissible as to trusts governed by Rhode Island and Oklahoma law, notes 51 and 53 *supra*.

<sup>88</sup> Treas. Reg. §2038-1(c) considers §2038(a)(2) limited to trusts where the power was reserved at the time of transfer, presumably because of *Poor*, but includes in a reserved power not only one arising by the express terms of the trust instrument but also one arising "... by operation of law. . . ."

<sup>89</sup> Repealed in 1942 La. Acts 1942, No. 187.

<sup>90</sup> *Estate of Felicia Gimbel Keiffer*, 44 B.T.A. 1265 (1941); *Howard v. United States*, 125 F. 2d 986 (5th Cir. 1942); *Vaccaro v. United States*, 149 F. 2d 1014 (5th Cir. 1945).

<sup>91</sup> 38 B.T.A. 871 (1938).

<sup>92</sup> *Id.* at 873-874. *Poor* was considered inapplicable because of the language of the gift tax statute.

<sup>93</sup> 108 F. 2d 961 (3rd Cir. 1939), *cert. denied*, 309 U.S. 680 (1940).

The respondent misinterprets the meaning of the *Helmholz* case where the court said that the Government's "argument overlooks the essential difference between a power to revoke, alter, or amend, and a condition which the law imposes." . . . What the court was there pointing out was that the power in the beneficiaries, as such, to revoke a trust was a legal right<sup>94</sup> which they also enjoyed without any grant in the premises from the settlor. The power, therefore, could not be one reserved to the settlor, as such, within the contemplation of Sec. 302(d) of the Estate Tax Act of 1926. Otherwise, Congress would be attempting to tax, as a part of a deceased settlor's estate, in States where beneficiaries have the legal right to terminate a trust, property with which the settlor had irrevocably parted in his lifetime, so far as any power, on his part as settlor, to terminate the trust was concerned. This, of course, Congress could not do without violating the Fifth Amendment . . . and, an attempt so to do was not to be imputed to Congress by adopting the construction of Sec. 302(d) . . . for which the Government was contending. The thing of importance in the *Helmholz* case was that the power of revocation rested with the beneficiaries and not with the settlor as such. The ruling in the *Poor* case so implies. In the latter case, the trustees did not have a power to revoke conferred by law as did the beneficiaries in the *Helmholz* case. The trustee's power to revoke came from the trust indenture alone. Yet the result in the *Poor* case was the same as in the *Helmholz* case. Neither the *Helmholz* case nor the *Poor* case distinguishes between a settlor's power to revoke when imposed by law and a settlor's like power when reserved by his trust indenture.<sup>95</sup>

Yet this reasoning satisfied both the Board and the Fifth Circuit when faced with gifts made revocable by the Louisiana statute.<sup>96</sup>

#### B. *Power of Modification*

Under state law a power of revocation is normally considered a power reserved in the settlor to terminate the trust and recapture the trust assets while a power of modification does not result in the termination of the trust but rather a change in the dispositive or administrative provisions.<sup>97</sup> However, there can be an overlap. "Ordinarily a general power to revoke the trust will be interpreted as authorizing the settlor . . . to modify the terms of the trust, and it will be unnecessary for the

<sup>94</sup> Although this statement seems to refer to the right of all beneficiaries to compel a termination of a trust except where its continuance is necessary to carry out a material purpose of the settlor in creating it, the court here cites "Restatement of the Law of Trusts, Secs. 337, 338." As noted previously, the latter section deals with the right of the settlor in conjunction with all the beneficiaries to terminate the trust. See note 75 *supra*.

<sup>95</sup> 108 F. 2d 961, 965.

<sup>96</sup> Note 90 *supra*. Cf. *Frenley v. Phinney*, 3 A.F.T.R. 2d 1857, 59-1 U.S.T.C. ¶11876 (W.D. Tex. 1959), where an attempt to tax assets of a trust created in 1950 and subject to Texas law failed, the court finding the trust instrument showed an intent to make the trust irrevocable. The Texas statute, note 54 *supra*, was not mentioned.

<sup>97</sup> See *Avery v. Bender*, 119 Vt. 313, 126 A. 2d 99 (1956).



settlor first to revoke the trust and then create a new trust."<sup>98</sup> Contrari-wise, if a "... power to modify is subject to no restrictions, it includes a power to revoke the trust."<sup>99</sup> This result is based on the reasoning that under such a power the settlor could exclude all other beneficiaries and make himself the sole beneficiary.<sup>100</sup> When a settlor is sole beneficiary and not under any incapacity, he can compel termination of the trust even though his original purpose in creating the trust has not yet been accomplished<sup>101</sup> and the terms of the trust provide that it is irrevocable.<sup>102</sup> Hence, if a settlor purports to create an irrevocable trust but reserves an unrestricted power to modify the trust, such a power would be subject to section 2038.<sup>103</sup>

Even where a settlor creates a trust wherein he reserves a power of modification so restricted that it does not include a power of revocation, can such a power be exercised in a way which would cause termination of the trust in favor of persons other than the settlor? In *Porter v. Comm'r*<sup>104</sup> the settlor reserved a power under which he could

... by instrument in writing ... delivered to the trustee, or its successor, modify or alter in any manner this indenture, and any or all of the trusts then existing and the limitations and estates and interest in property hereby created and provided for subsequent to such trusts; and in case of such modification or alteration said instrument shall direct the revised disposition to be made of the trust fund or the income thereof, or that part of the trust fund or the income thereof affected by such modification or alteration, and upon the delivery of such instrument to the Trustee or its successor said instrument shall take effect according to its provisions, and the Trustee or its successors shall make and execute all such instruments, if any, and make such conveyance, transfers or deliveries of property as may be necessary or proper in order to carry the same into effect, and no one, born or unborn, shall have any right, interest, or estate under this indenture except subject to the proper modification or alteration thereof; but this power to modify or alter is not intended and shall not be construed to include the right to the Donor to make such modification or alteration in his own favor or in favor of his estate, but shall apply only so far as the interest of third parties may be concerned.<sup>105</sup>

<sup>98</sup> RESTATEMENT (SECOND), TRUSTS §331 comment *g* (1959); *Lambdin v. Dantze-becker*, *supra* note 40.

<sup>99</sup> *Id.*, comment *h*.

<sup>100</sup> SCOTT, TRUSTS §331.2 (2d ed. 1956).

<sup>101</sup> RESTATEMENT (SECOND), TRUSTS §339 (1959).

<sup>102</sup> *Id.* §331, comment *i*.

<sup>103</sup> No cases squarely in point have been found since §2038 includes a power to modify which does not include a power to revoke the trust. *Estate of Sidney F. Tyler*, 40 B.T.A. 330 (1939), *aff'd*, 109 F. 2d 421 (3rd Cir. 1940); *Estate of Thomas E. Steere*, 22 T.C. 79 (1954), *aff'd sub nom.*, *Rhode Island Hospital Trust Co. v. Comm'r*, 219 F. 2d 923 (1st Cir. 1955), both involving trusts where the settlor had originally reserved both a power to revoke and a power to modify and subsequently released only the former.

<sup>104</sup> 288 U.S. 436 (1933).

<sup>105</sup> *Id.* at 439 n.2. The court did not specifically consider whether the settlor held

The court held that under this clause ". . . the donor retained until his death power enough to enable him to make a complete revision of all that he had done in respect to the creation of the trusts *even to the extent of taking the property from the trustees and beneficiaries named and transferring it absolutely* or in trust for the benefit of others."<sup>106</sup>

The taxpayer argued that ". . . as decedent was without power to revoke the transfers or to alter or modify the trusts in favor of himself or his estate, the property . . ." was not includible in decedent's gross estate under section 302(d) of the Revenue Act of 1926. The court disagreed, stating:

But the disjunctive use of the words "alter," "modify" and "amend" negatives that contention. We find nothing in the context or in the policy evidenced by this and prior estate tax laws or in the legislative history of subdivision (d) to suggest that conjunctive use of these words was intended, or that "alter" and "modify" were used as equivalents of "revoke" or are to be understood in other than their usual meanings.<sup>107</sup> We need not consider whether every change, however slight or trivial, would be within the meaning of the clause. . . .<sup>108</sup> So far as concerns the tax here involved, there is no difference in principle between a transfer subject to such changes and one that is revocable. The transfers under consideration are undoubtedly covered by subdivision (d).<sup>109</sup>

Where a settlor reserves a power of modification so restricted that under state law it would be considered a special power of appointment<sup>110</sup>

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this power in a fiduciary capacity, note 30 *supra*, but, considering the language subordinating the interest of others to the exercise of this power, it would seem that it was not held for the benefit of any persons who would have standing in court to object to its exercise or nonexercise. The court did observe that ". . . evidently he intended to be free at any time and from time to time alter or modify the disposition of the property as he might see fit, . . ." *Id.* at 440.

<sup>106</sup> *Id.* at 443. (Emphasis added.)

<sup>107</sup> Actually, §302(d) listed only a power to alter, amend, or revoke and had been previously quoted verbatim by the court. *Id.* at 441. Because the instrument under consideration used the words "modify or alter," the court may have been indicating that "alter," "amend," and "modify" were synonymous.

<sup>108</sup> For cases where this has been considered a limitation on §2038 justifying exclusion of transfers from a decedent's gross estate, see MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §25.06 (1959).

<sup>109</sup> 288 U.S. 436, 443. Unless a settlor qualifies under the detailed requirements of §2038(c), intervening incompetency does not bar inclusion of the property in the settlor's gross estate. See note 6 *supra*.

<sup>110</sup> RESTATEMENT, PROPERTY §320(2) (1940). The American Law Institute did not use the terms "power in trust" and "power not in trust" in classifying special powers of appointment. "The use of the term 'power in trust' in the sense of 'mandatory power' or 'imperative power' is potentially misleading. This usage seems to have arisen and to be chiefly important with reference to powers of sale in executors and trustees. To say that a power of sale is mandatory is to indicate that its exercise can and will be compelled. . . . But the situation is different with reference to a power of appointment. Even though it is concluded that the donor intended to require the donee to appoint, judicial pressure upon the donee is normally an impossibility, since almost invariably there is no breach of the duty to exercise the power until the donee is dead; and even

and also a special power not taxable under section 2041, it can still result in inclusion of the trust assets in a deceased settlor's gross estate under section 2038.<sup>111</sup> Thus, in *Equitable Trust Co. of New York, Administrator*<sup>112</sup> a settlor created an irrevocable trust under which on her death the principal was to be paid "... to the lawful descendants of the party of the first part in such proportions as the party of the first part shall in and by her last will and testament appoint, and in case of failure to make such testamentary appointment, then to such descendants absolutely in equal shares per stirpes and not per capita; ..."<sup>113</sup> She died intestate and was survived by three children. The Commissioner included the trust assets in her gross estate on the ground that she had "... reserved the right to appoint in her will the proportions of the principal distributable to her lawful descendants . . ." and this constituted a power to alter or amend within the provisions of section 302(d) of the Revenue Act of 1926. But the Board disagreed, stating:

The decedent retained the power to fix the share of each one of the group of takers. But as she had not theretofore fixed the share each was to take, the retained power to fix for the first time was not a power to change. If she failed to exercise the power an alternative provision in the trust instrument became effective, under which they were to take equally. The retained power was a power to supplement, amplify, or make more specific, but not to alter or amend. . . . The present case differs also from one wherein a power to change beneficiaries is retained. (d) would apply to that case. . . . Here the decedent could not divest the class named as remaindermen, but could only designate the proportions in which the members of the class would take.<sup>114</sup>

On appeal, the Board was reversed.<sup>115</sup> The Second Circuit held:

if the donee is alive the court will not undertake to compel him to appoint because the exercise of the discretion is considered incapable of being effectively compelled, and will not make an appointment in his stead because the discretion of choice among objects is considered personal to the donee.

"The use of the term 'power not in trust' involves somewhat similar difficulties. All special powers have one or more characteristics of a trust. For instance, no donee of any special power can derive personal profit from an appointment (see Sections 351-355). It is therefore preferable not to refer to any special power as a 'power in trust.'" *Id.*, comment *a*, special note. Cf. RESTATEMENT (SECOND), TRUSTS §§120-122 (1959).

<sup>111</sup> On the precedence given §2038 here over §2041, see LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES §12.1, at 254-255 (2d ed. 1962).

<sup>112</sup> 31 B.T.A. 329 (1934).

<sup>113</sup> *Id.* at 332.

<sup>114</sup> *Id.* at 336-337. The Board may have considered the special power retained here as one where the settlor-donor had a special fiduciary obligation (see note 110 *supra*) under the state law. That is, the American Law Institute, distinguishes between special powers of appointment which are exclusive, where the donee can appoint all of the property to one or more of the possible appointees to the exclusion of the others, and special powers which are non-exclusive, where the donee is under an obligation to appoint a substantial amount to each member of the class. RESTATEMENT, PROPERTY §§360-361 (1940). See SIMES & SMITH, THE LAW OF FUTURE INTERESTS §982 (1956).

<sup>115</sup> *Sub nom. Comm'r v. Chase Nat. Bank*, 82 F. 2d 157 (2d Cir. 1936), *cert. denied*, 299 U.S. 552 (1936).

We think subdivision (d) authority for the inclusion of the trust corpus in the decedent's gross estate. Up to the time she died she had the power to alter the proportions in which her descendants should take the property in accordance with the original terms of the trust instrument. *She could have limited any, or all but one, of them to a nominal amount and given all of real value to one or to such of them as she pleased.* Her death eliminated the possibility of any such change in the provisions of the deed of trust and made it certain that her lawful descendants would take the property in equal shares per stirpes. The power she reserved was not to change the trust provisions in a trivial way, but went right to the heart of them and gave the decedent a substantial though qualified control over the trust property until her death. Such a power to alter or amend the substance of the transfer by trust brought it within the scope of the decision in *Porter v. Commissioner*. . . . The decedent, having the right to change the economic benefit, had the power to alter within section 302(d) of the 1926 Act even though she could not benefit herself in a pecuniary way by the change.<sup>116</sup>

Where the decedent has retained an exclusive power of appointment, which would in effect be a power to change beneficiaries, such a power is clearly subject to section 2038.<sup>117</sup> But where decedent has retained a non-exclusive power in a jurisdiction which invalidates illusory appointments,<sup>118</sup> the decedent may possibly have to be able to terminate the trust by the exercise of the power, thereby accelerating enjoyment of the property free of the trust,<sup>119</sup> in order to bring the power within the ambit of section 2038.<sup>120</sup>

Where a settlor has reserved a bare power to terminate the trust prematurely in favor of persons other than himself, the question has arisen

<sup>116</sup> 82 F. 2d at 158. (Emphasis added.) It is doubtful if the Second Circuit gave adequate consideration to the question of whether the decedent had an exclusive or non-exclusive power under state law. See note 114 *supra*. While state law classifications of power of appointment have been disregarded for tax purposes, note 61 *supra*, it would seem that a classification which determines what the decedent could in fact do with her retained power should have been considered first and then whether this amounted to a power of modification for tax purposes. If the decedent had a nonexclusive power under state law, the American Law Institute's position is that a substantial part of the appointive assets must be received by each member of the class. RESTATEMENT, PROPERTY §361 (1940). Under this approach, any appointment of a nominal amount to one or more descendants would be considered an illusory appointment and an ineffective exercise of the power. *Id.*, comment f. A number of jurisdictions have repudiated the latter doctrine. SIMES & SMITH, *supra* note 114. Since the trust considered by the Second Circuit was governed by the New York law, N. Y. REAL PROP. LAW §158 (1896) might have been interpreted as making all special powers exclusive in that state. *Id.* But then the decedent would not have to make even a nominal appointment to all of her descendants.

<sup>117</sup> Bank of New York & Trust Co., 20 B.T.A. 677 (1930).

<sup>118</sup> Simes & Smith, *supra* note 114.

<sup>119</sup> The development of this doctrine is outlined in the following paragraphs of the text.

<sup>120</sup> It appears that the trust considered by the Second Circuit was to terminate at the decedent's death whether she exercised her reserved power or not. See text preceding notes 113 and 114 *supra*.

as to whether this power must include an ability to determine which persons are to take the trust corpus, so that, in effect, such a power to terminate is really a power to change beneficiaries. Thus, in *Estate of Harry Holmes*<sup>121</sup> a settlor declared himself trustee of three irrevocable trusts for the benefit of his three sons. Should the settlor die during the continuance of the trusts, such of his sons as were then of legal age were named as successor trustees. As trustee, the settlor had both a discretionary power to distribute income to the three sons or add it to corpus and a power to invade corpus for the benefit of the sons. The latter were to receive the corpus in 15 years if they were then living, if not, there were gifts over to their issue with a variety of alternative dispositions, to persons other than the settlor, if a man died without issue. However, the trust also provided for an earlier termination.

And Grantor may, during his lifetime, if deemed advisable by him, and my son or sons herein named, which acting as Trustee hereunder, may, if deemed advisable by them as Trustee, terminate either or all of said trusts herein created for the respective benefit of my said sons, and distribute the principal of the trust to the persons entitled to receive the same under the terms hereof on the date of such termination.<sup>122</sup>

The trusts having been created in 1935 and the settlor having died in 1940 survived by his three sons, the Commissioner contended that the trusts were includible in the decedent's gross estate under section 811(d)(2) of the Internal Revenue Code of 1939.<sup>123</sup> But the Tax Court disagreed, stating:

In the instant case the remainder interests in the trust corpus, as well as the right to receive the income during the term of the trust, subject to the right of the trustee to either distribute or accumulate the income for the named beneficiaries, were irrevocably vested in the three beneficiaries by the trust indenture itself, and an exercise by the settlor of his power to terminate the trust meant only an acceleration of the time of enjoyment. The settlor reserved no power whatsoever to change the portions of the corpus which each beneficiary was to receive. . . . [I]n transfers made on or prior to June 22, 1936, where the settlor has retained only a power to terminate the trust and has retained no power to revest in himself or in his estate any part of the trust corpus or to change or alter the disposition of the trust corpus already given to the beneficiaries under the terms of the trust indenture, but only to accelerate the time of its enjoyment, we do not think the value of the trust corpus is includible under section 811(d)(2).

. . .<sup>124</sup>

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<sup>121</sup> 3 T.C. 571 (1944).

<sup>122</sup> *Id.* at 573.

<sup>123</sup> "New Section 2038(a)(2)."

<sup>124</sup> 3 T.C. 571, 577.

On appeal, the Commissioner contended that more was involved than merely a power to ascertain enjoyment since

... the reservation by the decedent of the power to terminate the trusts at will enabled him to give to the then existing beneficiaries complete ownership of the trust corpus, and thereby to extinguish all contingent interests; and that the relinquishment of this power by the decedent at death was the first complete transfer of the grantor's control over the enjoyment of the trust benefits.<sup>125</sup>

A majority of the Fifth Circuit judges were unimpressed<sup>126</sup> but the dissenting judge was of the opinion

... that termination of the trust would accomplish much more than "to accelerate the time of the enjoyment"; that the corpus was not by the instrument "already given to the beneficiaries," but on the contrary, the grantor could "change or alter the disposition of the trust corpus" by transforming some contingent interests into absolute ownership and thereby destroy other contingent interests altogether.<sup>127</sup>

While each of the three sons named as beneficiaries were given a present interest in the income from the trust, even that interest was not absolute. The grantor had the right as trustee to withhold income payments "should he determine it for the best interest of" the named beneficiaries. This, together with the spendthrift provisions, insured continuing control over the income by the grantor. Moreover, he reserved the right to terminate the trust at any time in his lifetime. If the trust were terminated in this manner, the corpus would be paid to the beneficiaries then entitled to it. Thus, by exercising his retained authority, the grantor could have changed the contingent interests of his three sons with respect to the corpus into rights of absolute ownership. By the same token, had he terminated the trust, he could have extinguished the contingent interest which each son had in his brother's putative shares, the contingent interests which the issue, or potential issue, of each son would have, and also the contingent interest of the grantor's wife.<sup>128</sup>

The Supreme Court agreed that more than mere acceleration of enjoyment was involved.

It seems obvious that one who has the power to terminate contingencies upon which the right of enjoyment is staked, so as to make certain that a beneficiary will have it who may never come into it if the power is not exercised, has power which affects not

<sup>125</sup> *Comm'r v. Estate of Holmes*, 148 F. 2d 740, 751 (5th Cir. 1945).

<sup>126</sup> "Since the reservation in the present case did not empower the donor either to revoke the trust instrument and recapture the trust property, or to modify the terms of that instrument so as to designate new beneficiaries or in any other manner change the fixed provisions thereof, it is patent that the Commissioner is now seeking to extend the rule beyond the bounds long established." *Id.*

<sup>127</sup> The quotations are from the Tax Court's opinion. See text preceding note 124 *supra*.

<sup>128</sup> 148 F. 2d 740, 743.

only the time of enjoyment but also the person or persons who may enjoy the donation. More therefore is involved than mere acceleration of the time of enjoyment. The very right of enjoyment is affected, the difference dependent upon the grantor's power being between present substantial benefit and the mere prospect or possibility, even the probability, that one may have it at some uncertain future time or perhaps not at all. A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which section 811(d)(2) requires in order to avoid the tax.<sup>129</sup>

The emphasis in the *Holmes* decision on the settlor's power to not merely accelerate enjoyment but also determine who would actually enjoy the corpus left open the question of whether a retention of a power to terminate prematurely, where the right to receive the corpus was indefeasibly vested at all times, was also within the scope of section 2038. In *Lober v. United States*<sup>130</sup> the settlor had declared himself trustee of three irrevocable trusts for the benefit of his three minor children. During their minority the settlor as trustee had a discretionary power to accumulate any part of the income. Upon reaching the age of 25 each child was entitled to the corpus of his trust and there was no provision for a gift over if a child died before reaching that age. The settlor as trustee had a discretionary power to distribute part or all of the corpus to the beneficiary of each trust before the latter reached the age of 25. The settlor having died before any of the children had reached the age of 25 and without having exercised his power to terminate the trusts, the Government urged

. . . that the decedent here had the power to terminate the trusts by paying over the trust assets to the beneficiaries at any time before they would have had to be so paid under the terms of the trust instruments, and that therefore the assets were covered by section 811(d)(2) as interpreted in the *Holmes* case.

The plaintiffs distinguish the *Holmes* case, *supra*, upon the ground that there the trust instrument provided for a gift over to other persons if a primary beneficiary should not survive the fifteen year period of the trust, and had not received the principal prior to his death. . . . In the *Holmes* case, then, the settlor trustee could, by terminating the trust by the payment over of the principal before the required date, cut off the potential interests of various persons who might have received the property

<sup>129</sup> *Comm'r v. Estate of Holmes*, 326 U.S. 480, 487 (1946). With this emphasis on the decedent's power to not merely accelerate enjoyment but also determine the persons who were to enjoy the corpus, the court presumably could have found that the decedent in effect had a power to change beneficiaries and thus avoided the question of whether the tax statute, as it existed prior to the 1936 amendments (note 80 *supra*), included a power of termination. But, after consideration of the legislative history, the court had no difficulty in concluding that this particular amendment was merely declaratory of pre-existing law. *Id.* at 487-488.

<sup>130</sup> 108 F. Supp. 731 (Ct. Cl. 1952).

if it had been kept in trust and the beneficiary had died before the time when payment of the principal was mandatory.

The plaintiffs urge that in the instant case the settlor could, but the premature payment over of the principal, only cut off the chance of the heirs of the beneficiary to enjoy the property, as they would have done if the property had been kept in the trust and the beneficiary had died before reaching the age of twenty-five.<sup>131</sup>

Although the Government had contended that the children did not have indefeasibly vested interests so that upon their death prior to reaching the age of 25 the assets would have reverted to the settlor by reason of the failure of the trust,<sup>132</sup> the Court of Claims was willing to

... assume, for present purposes that ... the beneficiary had an inheritable interest in the trust *res* so that the right to receive the principal would have passed to his estate, rather than returning to the settlor, which would seem to be the only other possible disposition of it.<sup>133</sup>

After quoting from the Supreme Court's opinion in the *Holmes* case, the Court of Claims stated:

This reasoning seems to us to be conclusive of the instant case. The power of the settlor to pay over the principal was, in truth, the power to determine whether the beneficiary should, or should not, have the enjoyment of the property. As the Supreme Court said, it was not a mere question of acceleration of payment, of whether he should enjoy the property sooner or later, but whether he should enjoy it at all, or not. The identification of a living person with his heirs, as in the Rule in Shelley's Case, or the doctrine of worthier title, has no doubt served some purpose in our land law. But for the practical purpose of determining whether the creator of a trust has retained enough of the incidents of ownership or control to make it probable that Congress intended to tax the trust *res* as a part of his estate, such an identification lacks reality. A father who has the power to decide that his son should have certain assets to use, enjoy, spend, waste or invest, or to decide that he shall not have them at all for any of these purposes, or collateral relatives should have them, has a significant control over the assets. We think it is substantially the kind of control which the Supreme Court was dealing with in *Commissioner v. Holmes*.<sup>134</sup>

The Supreme Court was also willing to assume that each of the children had an indefeasibly vested interest in the trust corpus so that if he died before reaching 25 this interest would pass to the child's estate.

<sup>131</sup> *Id.* at 732.

<sup>132</sup> Here the Government appears to have been relying on the state law rule that a resulting trust arises in favor of the settlor by operation of law when an express trust fails. See RESTATEMENT (SECOND), TRUSTS §411 (1959).

<sup>133</sup> 108 F. Supp. 731, 732.

<sup>134</sup> 108 F. Supp. 731, 732-733.



Petitioners stress a factual difference between this and the Holmes Case. The Holmes trust instrument provided that if a beneficiary died before the expiration of the trust his children succeeded to his interest, but if he died without children, his interest would pass to his brothers or their children. Thus the trustee had power to eliminate a contingency that might have prevented passage of a beneficiary's interest to his heirs. Here we assume that upon death of the Lober beneficiaries their part in the trust estate would, under New York law, pass to their heirs. But we cannot agree that this difference should change the Holmes result.

We pointed out in the Holmes Case that section 811(d)(2) was more concerned with "present economic benefit" than with "technical vesting of title or estates." And the Lober beneficiaries, like the Holmes beneficiaries, were granted no "present right to immediate enjoyment of either income or principal."<sup>135</sup> The trust instrument here gave none of the Lober children full "enjoyment" of the trust property, whether it "vested" in them or not. To get this full enjoyment they had to wait until they reached the age of twenty-five unless their father sooner gave them the money and stocks by terminating the trust under the power of change he kept to the very day of his death.<sup>136</sup> This father could have given property to his children without reserving in himself any power to change the terms as to the date his gift would be wholly effective but he did not. What we said in the Holmes Case fits this situation too: "A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which section 811(d)(2) requires in order to avoid the tax. . . ."<sup>137</sup>

While doubt has been expressed as to whether the *Lober* decision clearly establishes that the settlor's retention of merely a power to accelerate the time when the trust corpus is to be distributed subjects the trust assets to inclusion under section 2038, since Lober also had a discretionary power to accumulate income during the minority of the children,<sup>138</sup> the failure of the Court to refer to its language in the *Holmes* opinion explaining why Holmes had more than a mere power to ac-

<sup>135</sup> It has been stated that one of the children had reached 21 prior to their father's death and that he then apparently had a present right to income. Note, 4 DUKE BAR J. 28 n.3, 32 (1954). If so, it would appear that the Court was not aware of this. Cf. LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES, §9.10 n.93 (2d ed. 1962).

<sup>136</sup> Under the state law of trusts, a sole beneficiary cannot compel a premature termination of the trust even in this fact situation. RESTATEMENT (SECOND), TRUSTS §337, comment j (1959). The Court did not attempt to determine whether each child's right to corpus was assignable under New York law. See N.Y. REAL PROP. LAW §103 (1936). N.Y. PER. PROP. LAW §15 (1961). Presumably, the "full enjoyment" referred to by the court means present ownership of the assets as distinguished from a right to sell a future interest in them.

<sup>137</sup> *Lober v. United States*, 346 U.S. 335, 337 (1953).

<sup>138</sup> MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §25.41 (1959). Cf. note 135 *supra*.

celerate enjoyment of the trust assets, plus the Court's refusal to even discuss the lead offered by the Court of Claims as to the Lober trusts, i.e., that Lober had a power to choose his children rather than their heirs, supports the conclusion that a mere power to accelerate distribution of trust assets is subject to section 2038.<sup>139</sup> This appears to be the Treasury's position.<sup>140</sup>

## II. TERMINATION BY A TRUSTEE ACTING ALONE

### A. *Where a Settlor is Also a Trustee*

Under state law a settlor may declare himself trustee of certain assets for the benefit of others,<sup>141</sup> transfer assets to himself as co-trustee with one or more persons,<sup>142</sup> or subsequently be appointed trustee of a trust he has created.<sup>143</sup> Irrespective of the method by which he became trustee, acceptance of this position<sup>144</sup> subjects the settlor to a number of judicially developed fiduciary duties<sup>145</sup> except to the extent that those have been modified by state statute<sup>146</sup> or can be and are altered by the terms of the trust instrument.<sup>147</sup> On the other hand, acceptance of the position as trustee vests in the settlor certain powers exercisable in his fiduciary capacity. Such powers may be either expressly or by implication conferred by the terms of the trust instrument,<sup>148</sup> by judicial authorization,<sup>149</sup> or by state statute.<sup>150</sup>

According to the American Law Institute, a fiduciary power may be classified under state law as either mandatory or discretionary. If a trustee is under a duty to the trust beneficiaries to exercise or not to exercise a particular power, the latter is a mandatory power. But if the trustee has a privilege but not a duty to exercise the power, it is classified as discretionary.<sup>151</sup> However, the Institute also recognizes the possi-

<sup>139</sup> Since *Lober* involved pre-1936 trusts, such a power is taxable under §2038 (a) (2) as well as under §2038(a) (1).

One commentator has suggested that, as a matter of policy, such a power should not be taxable under §2038, at least while the present version of §2037 is in effect. Pedrick, *Grantor Powers and Estate Taxation: The Ties That Bind*, 54 NW. U. L. REV. 527, 532-535 (1959).

<sup>140</sup> "Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected." For example, §2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust." (Emphasis added) Treas. Reg. §20.2038-1(a).

<sup>141</sup> RESTATEMENT (SECOND), TRUSTS §17 (1959).

<sup>142</sup> *Id.* §100, comment a.

<sup>143</sup> This may occur because the terms of the trust instrument permit another person or persons to fill vacancies or, where such mechanism is lacking or ineffective, a vacancy may be filled by court appointment. *Id.* §109.

<sup>144</sup> *Id.* §102.

<sup>145</sup> *Id.* §§169-185.

<sup>146</sup> *E.g., id.* §170, comment m.

<sup>147</sup> *Id.*, comment t.

<sup>148</sup> *Id.* §186.

<sup>149</sup> *E.g., id.* §189, comment d.

<sup>150</sup> *E.g., id.* comment f.

<sup>151</sup> *Id.* §186, comment e. Cf. text at notes 27-29 *infra*.

bility of a hybrid power under which the trustee is under a duty to exercise the power but has discretion as to the time, manner and extent of its exercise.<sup>152</sup> Even where the trustee is not under a duty to exercise a power, the trustee is subject to court control if his decision to exercise or not to exercise the power is the result of an abuse of his discretion.<sup>153</sup> Among the factors to be considered here are "... the extent of the discretion conferred upon the trustee by the terms of the trust ... [and] the existence or non-existence, the definiteness or indefiniteness, of an external standard by which the reasonableness of the trustee's conduct can be judged. . . ."<sup>154</sup> The Institute considers these two factors interrelated. Hence if a measurable standard is present,

... the court will control the trustee in the exercise of a power where he acts beyond the bounds of a reasonable judgment, unless it is otherwise provided by the terms of the trust. . . .<sup>155</sup> The settlor may, however, manifest an intention that the trustee's judgment need not be exercised reasonably, even where there is a standard by which the reasonableness of the trustee's conduct can be judged. This may be indicated by a provision in the trust instrument that the trustee shall have "absolute" or "unlimited" or "uncontrolled" discretion.<sup>156</sup> These words are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness.<sup>157</sup> In such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not a sufficient ground for interposition by the court, so long as the trustee acts in a state of mind in which it was contemplated that he would act. But the court will interfere if the trustee acts in a state of mind not contemplated by the settlor.<sup>158</sup> Thus, the trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily without an exercise of his judgment.<sup>159</sup>

One of the discretionary powers which may be conferred upon a trustee expressly in the trust instrument is a discretionary power to terminate the trust. According to the Institute, if the trust instrument

<sup>152</sup> *Id.* §187, comment *a*.

<sup>153</sup> *Id.* §187.

<sup>154</sup> *Id.* comment *d*. In determining the reasonableness of the trustee's conduct a court is not to substitute its own judgment but rather the test is whether any reasonable person might have conducted himself as the trustee did. *Id.*, comment *e*.

<sup>155</sup> *Id.* comment *i*.

<sup>156</sup> A recent study of discretionary powers as to income and principal payments uses the phrase "extended discretion" to distinguish such powers. Halbach, *Problems of Discretion in Discretionary Trusts*, 61 COL. L. REV. 1425, 1428-1433 (1961).

<sup>157</sup> The study referred to in the preceding footnote reports that no cases have been found to support this statement in the area of powers related to income and principal payments. *Id.* at 1431.

<sup>158</sup> "... [A]ny distinction between the test of reasonableness and the state-of-mind test is difficult to discern from the holdings of these cases." *Id.* at 1432.

<sup>159</sup> RESTATEMENT (SECOND), TRUSTS §187, comment *j* (1959).

provides a standard for measuring the reasonableness of the trustee's judgment in exercising or not exercising such a power, he is subject to judicial review as to the reasonableness of his conduct, unless the trust instrument gives him an absolute or other extended discretion as to the exercise or non-exercise of the power. In the latter situation and also where the trust provides no measurable standard, judicial intervention is limited to situations where the trustee acts dishonestly, arbitrarily, or from an improper motive.<sup>160</sup>

Taxwise, the issue is whether Congress intended section 2038 to apply only to situations where the settlor expressly gave himself as trustee a discretionary power to terminate the trust in favor of trust beneficiaries other than himself and his estate and, if so, whether the extent of judicial review over his decision to exercise or not to exercise the power is relevant in determining whether section 2038 should apply. Only one decision has been found which gives any specific consideration to the scope of the settlor's power as trustee.

In *Welch v. Terhune*<sup>161</sup> a settlor transferred assets to himself, his son, and his son-in-law as co-trustees. The trust provided: "This Trust may be terminated or amended at any time, but only with the written consent of the three Trustees herein named, . . ."<sup>162</sup> The trust having been created in 1929, the issue was raised as to whether a trust wherein the settlor had not reserved a power of termination as settlor but rather had granted such a power to himself as trustee was subject to section 302(d) of the Revenue Act of 1926. The court stated:

Nor does it matter that the trust instrument vested the power in Terhune in his capacity as a trustee named in the instrument rather than in his capacity as grantor. As previously noted, Section 302(d) refers to the existence of the power in the decedent, not to the capacity in which it is to be exercised. So far as we can see, nothing turns on whether the power now in question is to be described as a fiduciary or non-fiduciary power. It is enough that the grantor had retained in his hands a power, whether alone or in conjunction with others, to vary materially the enjoyment of the numerous property interests.<sup>163</sup>

<sup>160</sup> *Id.* §334, comment d.

<sup>161</sup> 126 F. 2d 695 (1st Cir. 1942), *cert. denied*, 293 U.S. 564 (1934).

<sup>162</sup> *Id.* at 696. The clause further provided that the consent of some of the trust beneficiaries was also required.

<sup>163</sup> In another portion of the opinion the court distinguished the *Poor* decision (see text preceding note 79 *supra*) as not involving a retained power and held that the 1936 amendments to §302(d) were merely declaratory of pre-existing law so far as they dealt with retained powers. 126 F.2d 695, 698-699. The Supreme Court had more difficulty with the effect of the 1936 amendment disregarding the capacity in which a power is held in the *Holmes* case, *supra* note 129. There the taxpayer had suggested that the power of termination had been held by the decedent as trustee rather than as settlor. The court considered the language of the trust instrument ". . . not wholly clear concerning the premise . . . If the question has been saved, we cannot say upon this language that the grantor did not reserve the power of termination to himself as donor rather merely as trustee. It is unnecessary

As a matter of fact, the power is probably not in a strict sense a fiduciary power. In *Reinecke v. Smith*, 1933, 289 U.S. 172, . . . the grantor, Douglas Smith, created a trust for the benefit of his wife and four children. The trustees named were the grantor, a son who was also a beneficiary of the trust, and a trust company. There was a provision that the trust might "be modified or revoked at any time by an instrument in writing signed by Douglas Smith . . . and either one of the other two trustees or their successors." The question was whether the income of the trust was taxable to the grantor under the provision of Section 219(g) of the Revenue Act of 1924, . . . providing that "Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." The income was held taxable to the grantor. In its opinion the court said:

In approaching the decision of the question before us, it is to be borne in mind that the trustee is not a trustee of the power of revocation and owes no duty to the beneficiary to resist alteration or revocation of the trust. Of course, he owes a duty to the beneficiary to protect the trustees, faithfully to administer it, and to distribute the income; but the very fact that he participates in the right of alteration or revocation negatives any fiduciary duty to the beneficiary to refrain from exercising the power. The facts of this case illustrate the point; for it appears the trust in favor of the grantor's wife was substantially modified, to her financial detriment, by the concurrent action of the grantor and the trustees. This case must be viewed, therefore, as if the reserved right of revocation had been vested jointly in the grantor and a stranger to the trust.<sup>164</sup>

therefore to determine whether, if the reservation were different, the variation in wording between §811(d)(1) and (2) in this respect would be material." 326 U.S. 480, 489-490. The Supreme Court considered the legislative history unclear on this point. *Id.* at 489 n.13. However, other lower courts have followed *Terhune*. MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §25.15 (1959). This may explain the failure of the taxpayer to raise the point in *Lober* where the settlor clearly held the power to terminate as trustee. See note 167 *infra*.

The Treasury admits that the 1936 amendments did change the law in overruling the *Poor* decision. Hence, ". . . the value of an interest in property transferred by a decedent before June 23, 1936, is not included in his gross estate under section 2038 unless the power . . . was reserved at the time of the transfer. For purposes of this paragraph, the phrase 'reserved at the time of the transfer' has reference . . . to any understanding, express or implied, had in connection with the making of the transfer that the power would later be created or conferred." Treas. Reg. §20.2038-1(c). On the source from which a decedent derived his power, see MERTENS, *op. cit. supra* note 163, §25.18.

<sup>164</sup> *Id.* at 698. The quoted language from the *Smith* case was in answer to the argument that it was unconstitutional to tax the settlor on income from property to which others had sole and exclusive title. "The argument proceeds upon the theory that until alteration or revocation of the trust the trustees held the legal title to the property for the sole benefit of the *cestuis*, and received the income; that both principal and income were beyond the control of the grantor. . . ." 289 U.S. 172, 175-176. The language was also

The emphasis on lack of any duty owed the trust beneficiaries suggests that not only did Terhune as trustee have a discretionary power but also one whose exercise or non-exercise was not generally subject to court review.<sup>165</sup> Presumably a power to terminate a trust "at any time" lacks any measurable standard enabling a court to review the reasonableness of the trustee's conduct under the state law approach of the Institute.<sup>166</sup> Such a standard has been lacking in other cases where an express power of termination retained by a settlor as trustee was considered subject to section 2038.<sup>167</sup>

Where a trustee has not been granted an express power to terminate the trust but the latter provides for invasion of corpus for the benefit of one or more of the trust beneficiaries, interpretive problems have arisen under state law as to whether such a trust can be terminated by an invasion of the corpus. In the first instance, there is the question of whether the trustee only has a mandatory power to invade corpus whenever the beneficiary requests an invasion and, if so, whether the beneficiary can demand the entire corpus. Thus, in *Connecticut Bank*

used apparently to distinguish *Reinecke v. Northern Trust Co.*, 278 U.S. 399 (1929) (discussed in text at note 4 *supra*) where the Supreme Court had declared unconstitutional an attempt to include in a deceased settlor's gross estate trusts created prior to the adoption of the federal estate tax wherein the settlor could revoke only with the consent of a beneficiary, since "... the interest of the beneficiary was adverse and the grantor unable at will to alter or destroy the trust." *Id.* at 176.

<sup>165</sup> Cf. *Union Trust Co. v. Driscoll*, 138 F. 2d 152 (3d Cir. 1943), where the decedent and her husband as co-trustees could "change or vary the relating proportions to be distributed to said beneficiaries upon final distribution as in their judgment said Trustees shall deem best." The court held: "Although the power of alteration was by the terms of the trust vested in the 'Trustees,' the settlor and one of the trustees were one and the same, the decedent. Describing the power possessed by her as a fiduciary one, if that it be, does not mean that she could not have exercised it, although its exercise would be restricted by legal consequences of those terms as applied to the management of the trust estate. See *Reinecke v. Smith*, 1933, 289 U.S. 172, ... But she could still change the enjoyment of the beneficial interests. Thus she still had a string attached to her beneficence, albeit that string was weaker than if she held it in the sole capacity of settlor. It was sufficient, we believe, to render the interests thus retained includible in her gross estate, ..." *Id.* at 154.

<sup>166</sup> Text preceding note 160 *supra*.

<sup>167</sup> In *Comm'r v. Newbold's Estate*, 158 F. 2d 694 (2d Cir. 1946), the settlor and another as co-trustees "... may on their own motion and in the exercise of their discretion at any time terminate this trust and divide the entire Trust Estate in the manner prescribed in paragraph VIII of this instrument, but before such termination shall be valid, the Trustee shall give six months' written notice in advance thereof to each beneficiary then alive."

In *Zirjacks v. Scofield*, 101 F. Supp. 307 (W.D. Tex. 1951), *aff'd*, 197 F. 2d 688 (5th Cir. 1952), the trust provided: "This trust may be sooner terminated at any time by the sole decision and in the sole discretion of the acting trustees or trustee hereunder."

In *Lober v. United States*, 346 U.S. 335 (1954), the exact terms of the settlor's power as trustee to terminate the trusts were not reproduced but the Supreme Court stated: "A crucial term of the trust instrument was that Lober could at any time he saw fit turn all or any part of the principal of the trusts over to the children. Thus he could at will reduce the principal or pay it all to the beneficiaries, thereby terminating any trusteeship over it." *Lober v. United States*, *id.* at 336.

*& Trust Company v. Lyman*,<sup>168</sup> the settlor had created a trust wherein, after the settlor's death, his wife was entitled to the net income for life. The trust provided that "payments of principal shall be made to or for the benefit of said Katherine R. Lyman either on the judgment of the Trustee as to their being needed because of her illness or absence or other emergency, or at the written request of said Katherine R. Lyman or for both of said reasons." Upon the death of the survivor of the settlor and his wife, the trust was to terminate and the corpus paid to the settlor's issue, if any, otherwise to certain charitable and educational institutions. Five weeks after the settlor's death the widow requested a payment of \$25,000 from principal and the trustee complied with the request. But when about five months later the widow requested that the entire principal be paid to her forthwith, the trustee instituted an action for construction of the trust to determine whether the widow was entitled to receive the entire principal as a matter of right, the widow not contending that she had any need for such an amount of money at that time. The court held that a widow had a right to the entire corpus.

Here, the same provisions as to invasion of principal were used in the case of the defendant as were used by the settlor in describing his own powers of invasion. The clear language is that payments of principal shall be made "at the written request" of the defendant. There is no uncertainty in this language. It is in sharp contrast to the provision, applicable to payments from principal made by the trustee on its own initiative, that they should be made to or for the benefit of the defendant "on the judgment of the Trustee as to their being needed because of her illness or absence or other emergency."

It is quite apparent that the settlor had two thoughts in mind with respect to invasion of the principal. The first was to order payments of principal to be made by the trustee, *suo motu*, on the basis of need. This would be particularly desirable in case the income beneficiary suffers any disability, mental or physical, of a type which seriously impaired or destroyed the power of communication or of judgment. The second was to order payments of principal to be made by the trustee at the untrammelled, written request of the beneficiary. Where, as here, the power of invasion is unconditionally given, it may not be restrained. We cannot rewrite the trust instrument to take it away.<sup>169</sup>

<sup>168</sup> 148 Conn. 273, 170 A. 2d 130 (1961).

<sup>169</sup> *Id.* at 279-280, 170 A. 2d at 133. *Cf.* *Matter of Woollard*, 295 N.Y. 390, 68 N.E. 2d 181 (1946), where the trustee was to pay the widow "... as much of the principal or corpus of my estate as she may deem necessary for her maintenance, comfort and well being (for which she shall not be required to make or file any account), . . . ." The lower court decision construing this language as giving the widow "... an absolute right to . . . all or any part of the corpus . . . as she shall deem necessary for her maintenance, comfort or well being, . . ." was modified to read "... the right . . . to such part of the corpus . . . as she shall deem necessary for her maintenance, comfort and well being, . . ." Yet whenever the widow so determined and

But where the terms of the trust stated that the trustees were to pay "the net income . . . semi-annually or oftener in the discretion of my said trustees to or for the use, benefit, comfort, support, and enjoyment of my wife, Mildred Park Keith. I authorize and empower my said trustees to make utilization of the principal for the foregoing purposes at such times and to such extent as my said wife, Mildred Park Keith, desires," the appellate court approved the lower court's construction of this language as giving the widow

. . . the right to request of the trustees reasonable payments from principal for her use, benefit, comfort and enjoyment and the trustees, when they find such requests to be reasonable and made in good faith, are authorized and empowered to make such reasonable payments from the principal to the widow on her request. . . .

The appellate court rejected the widow's contention that the trustee must honor requests for the purposes stated when made in good faith.

The language used in the will is not ambiguous. There is nothing to weaken the force of the words "authorize and empower" as words importing permission and implying discretion, rather than direction or command. . . . The use of the words "or oftener in the discretion of my said trustees" to qualify the otherwise unqualified obligation to pay income semiannually does not suggest that it was inappropriate or inconsistent to show an intent that there be discretion also as to payment of principal. It is plain that the phrase "at such times and to such extent as my said wife . . . desires" imports no inconsistency. The wife's desire, expressed, calls for the exercise of the trustees' judgment.<sup>170</sup>

If a trustee possesses a discretionary rather than a mandatory power to invade corpus, then a state court may be asked to decide whether the trustee has in effect a discretionary power to terminate the trust by turning over all of the corpus to the trust beneficiaries. In *Lees v. Howarth*<sup>171</sup> the trust provided:

In case in the sole and uncontrolled judgment of William T. Lees or his successor trustee it shall at any time or from time to time be deemed by him necessary, advisable or desirable to make any additional payments from the principal of said trust estate to my said son, Albert A. Howarth, in order to permit my said son to start in business for himself or with any other person, partnership or corporation or in order to provide more effectively for his comfort, well-being, maintenance or otherwise for his benefit, I

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stated the determination in writing to the trustees, the trustees had to comply with her demand. "Such a statement is all that may be required from the widow, since the statement itself imports the exercise by her of good faith and honest judgment, and under the terms of the particular will no one may question or go behind such a determination and expression by her." 295 N.Y. at 394, 68 N.E. 2d at 182.

<sup>170</sup> Keith v. Worcester County Trust Co., 338 Mass. 41, 42-43, 153 N.E. 2d 630, 631 (1958).

<sup>171</sup> 85 R.I. 321, 131 A. 2d 229 (1957).



hereby authorize and empower said trustees to make to my said son, or on his account, such payments from the principal of said trust estate as said William T. Lees or his successor trustee in his sole and uncontrolled judgment may deem necessary or advisable for the purposes of aforesaid. . . .

The exercise of the discretionary power imposed upon William T. Lees or his successor trustee to make payments from the principal of said trust estate to my son, Albert A. Howarth, shall be the sole and uncontrolled discretion of the said William T. Lees or his successor trustee, and I direct that when the said William T. Lees or his successor trustee so exercises his discretion, it shall be absolute, conclusive and binding on all parties concerned.

The court held:

It is clear from this language that the testator intended to place no further restriction on William T. Lees other than that imposed by law, namely, that he act in good faith in the exercise of his discretion.

We are therefore of the opinion that under the terms of the trust . . . it was the intention of the testator to vest authority in William T. Lees as trustee to turn over the entire trust estate at one time to the respondent if, in his sole and uncontrolled judgment, he deems it necessary or desirable to do so for the benefit of the respondent. It is also our opinion that . . . the exercise of such discretion by William T. Lees is subject to no further restrictions than that he act in good faith.<sup>172</sup>

Had the trustee not been given such an extended discretion, he might have had to adduce reasonable grounds for concluding that termination of the trust would benefit the settlor's son, provided "benefit" was a sufficient standard for testing the reasonableness of the trustee's decision.<sup>173</sup> Thus, in *Corkery v. Dorsey*<sup>174</sup> one O'Callaghan was trustee of a trust which provided that he was to

. . . pay over to Mary Louise Fay . . . when in the judgment of said O'Callaghan the said Fay is deserving and in need of aid, whatever part of said two thousand dollars . . . or its earnings that said O'Callaghan may deem for the best interests of said Mary Louise Fay, in such sums and at such times as he may deem expedient or necessary. . . .

Although the court found the trustee acted in good faith in concluding that he should turn over the entire corpus to the beneficiary as deserving and in need of aid in view of the condition of her health, her unemployment, and her approaching marriage, the trustee could not terminate the trust by merely exercising his judgment in good faith.

That fact, however, is not decisive. The power conferred upon the trustee was the exercise of reasonably sound judgment. No

<sup>172</sup> *Id.* at 327, 131 A. 2d at 232.

<sup>173</sup> *Cf.* Halbach, note 156 *supra*, at 1433.

<sup>174</sup> 223 Mass. 97, 111 N.E. 795 (1916).

arbitrary or capricious power was conferred even though honestly exercised. A trustee vested with discretionary power to distribute a fund in whole or in part is found to use reasonable prudence. Doubtless a trust might be created which by its terms would make the judgment of the trustee, however unwise it might be, the final test. . . . But the present instrument does not confer an uncontrolled and absolute discretion.<sup>175</sup>

The court went on to find that the beneficiary was deserving but not in need of the entire trust corpus so termination of the trust was not justified.<sup>176</sup>

Taxwise, the problem is whether a settlor who confers upon himself as trustee a power to invade corpus for the benefit of the trust beneficiaries should be considered as having a power to change enjoyment subject to section 2038. Since the latter encompasses not only a power to terminate the trust, but also a power to alter or amend it, taxability does not necessarily hinge on whether the settlor as trustee has a power to invade the entire corpus and thus terminate the trust. But the decisions do evidence concern as to the scope of the settlor's discretion as trustee. Unfortunately, an early decision considered the problem as one of determining whether the power was in existence at the settlor-trustee's death or whether it was contingent. The settlor and his co-trustees having a power to invade corpus when the net income was insufficient for the support, maintenance, and care of the income beneficiary, the Board held that since the trust income had never been insufficient during the settlor-trustee's lifetime the latter did not have a taxable power at the date of his death.

The power of the trustees to use any part of the trust corpus for the support and maintenance of Frank H. Patterson was contingent upon a state of facts which never arose, i.e., when the net income of the trust was insufficient for [his] comfortable support, maintenance and care. . . .

Since the power granted the trustees to disburse any part of the trust corpus . . . was not absolute, but conditional upon a certain contingency which did not happen during the decedent's lifetime and which he did not control, we hold that at the time of his death the decedent did not have the power, either alone or in conjunction with any other person, to change or alter the trust. . . .<sup>177</sup>

<sup>175</sup> *Id.* at 101, 111 N.E. at 796.

<sup>176</sup> *Cf. Kemp v. Patterson*, 6 N.Y. 2d 40, 159 N.E. 2d 661 (1959), where the trustees had a power to pay over "so much of the principal sums of this trust from time to time as the trustees may deem for the best interest of" the income beneficiary. Although the trustees determined in good faith that it was in the best interest of the income beneficiary to turn over the entire corpus to her and thereby reduce certain tax burdens, the court held that termination was not justified on these grounds and the beneficiary was not in need of the corpus for her maintenance and support.

<sup>177</sup> *Daisy Christine Patterson*, 36 B.T.A. 407, 413 (1937). The Board cited in support of its conclusion *Tait v. Safe Deposit & Trust Co. of Baltimore*, *supra* note 24.

Because of this initial approach to the problem, in *Estate of Albert E. Nettleton*,<sup>178</sup> where the settlor and his co-trustee had "the power in their uncontrolled discretion to use and apply from time to time such part of the principal of the trust estate held for any beneficiary as they may consider suitable and necessary in the interest and for the welfare of such beneficiary," the Tax Court held this power taxable, distinguishing the *Patterson* decision, not on the ground that the trustees had an extended discretion, but rather because the guides given the trustees in exercising their discretion were broader than in the *Patterson* case.

In this proceeding, however, the provision authorizing the trustees to pay principal "as they may consider suitable and necessary in the interests and for the welfare" of the beneficiary is so broad and all-embracing as not to require the alleged condition precedent that the life beneficiary be in need of the corpus. Where a trust sets forth such broad and embracing conditions that they do not describe definite events which may or may not occur, they are not real conditions precedent. . . . If the trustees, in their honest judgment, concluded that it would be for the best interest of the life beneficiary to have a large country estate, they could have invaded the corpus for that purpose. A decision of that nature is for the trustees and not for a court, although the court may review the question of good faith as a matter of fact. . . . The term "welfare" has a broad connotation and may denote a condition of happiness or prosperity. . . . In view of the wide range given to decedent, as trustee, to invade corpus, it would be difficult to place any reasonable bounds upon the possibility of his power of alteration. Under the circumstances, the power given to the trustees to disburse principal was not conditional upon any contingency, but was, for all practicable purposes, absolute.<sup>179</sup>

Although the reasoning as a whole suggests that a settlor-trustee does not have taxable power of invasion where the trust instrument contains no standard for measuring the reasonableness of the trustee's decision, the court apparently felt compelled to use extreme language in classifying the power as "for all practical purposes, absolute," in order to distinguish it from a contingent power. This language, rather than the absence of "any reasonable bounds," was used in a later case to describe a taxable power.

In *Estate of Milton J. Budlong*<sup>180</sup> the Tax Court cited the *Nettleton* case as an example of a power of invasion ". . . where no standard is

<sup>178</sup> 4 T.C. 987 (1945).

<sup>179</sup> *Id.* at 992-993. In *Estate of Cyrus C. Yawkey*, 12 T.C. 1164 (1949), the Tax Court reiterated the view that the interposition of a state court if a trustee acts in bad faith is not a sufficient limitation on his discretion to exclude a power from the ambit of §2038. However, the court went on to find the power contingent and, hence, not taxable, since it could not be exercised until the beneficiary reached the age of 30 and the settlor-trustee died before this event occurred. See note 21 *supra*.

<sup>180</sup> 7 T.C. 756 (1946), *aff'd and reversed in part on other issues sub. nom.* Industrial Trust Co. v. Comm'r, 165 F. 2d 142 (1st Cir. 1947).

provided, where the beneficiary has no enforceable right, and the invasion of corpus rests within the absolute discretion of the grantor as trustee."<sup>181</sup> But since Budlong as settlor-trustee had only a "power from time to time in his discretion . . . to expend from the principal of said trusts such amounts as he may deem necessary for the benefit of the respective beneficiaries thereof . . . in case of sickness or other emergency," the court stated: "It is obvious that the power in question gave the trustee no absolute and arbitrary control over the corpus. On the contrary, it was conditional and limited."<sup>182</sup> The court went on to emphasize the fact under state law the settlor-trustee could not act arbitrarily, because of the definite standard governing exercise of his power, in holding that this power was not subject to the predecessor of section 2038.<sup>183</sup>

Similarly extreme positions have been taken by the First and Second Circuits in classifying powers of invasion as taxable or not taxable. In *Hurd v. Comm'r*<sup>184</sup> the settlor and his wife as co-trustees had a power to invade corpus for the benefit of the wife. The trust provided that the trustees "may, if in their opinion the circumstances so require, pay over to or expend for the benefit of said Charlotte H. Hurd the whole or any part of the principle of the Trust Property." In holding this power taxable, the First Circuit observed:

The word "circumstances" as used in the trust instrument, is as wide as the world and to say that it imposes a legal limitation, or imports a controlling contingency, is to stretch it far beyond good sense. We entertain grave doubts that any equity court would harken to the complaints of a disaffected cestui who might interpose objections to the decedent's invasion of the principal for the use of his wife, irrespective of the "circumstances." The clause is not restricted to "her" circumstances, but rather to "the" circumstances. It is difficult to think of a broader reservation of powers than that contained in Clause III.<sup>185</sup>

<sup>181</sup> *Id.* at 763.

<sup>182</sup> *Id.* at 761.

<sup>183</sup> The American Law Institute considers a trustee to be acting arbitrarily where he fails to use his judgment by acting without knowledge of or injury into the relevant circumstances and distinguishes such conduct from the necessity of acting reasonably in exercising his judgment where there is a standard for measuring the reasonableness of his judgment. RESTATEMENT (SECOND), TRUSTS §187, comments *h* and *i* (1959).

<sup>184</sup> 160 F. 2d 610 (1st Cir. 1947), *aff'd* 6 T.C. 819 (1946).

<sup>185</sup> *Id.* at 612-613. Assuming that no standard for measuring the reasonableness of the settlor-trustee's conduct was present in *Hurd*, the American Law Institute's position is that such a trustee is still subject to judicial control if he acts in bad faith. RESTATEMENT (SECOND), TRUSTS §187, comment *i* (1959). It is, of course, possible that the First Circuit was aware of this limitation and considered it insufficient to prevent taxation. See *Estate of Cyrus C. Yawkey*, *supra* note 179.

In the *Hurd* case, the mental incompetency of the decedent for more than a year prior to his death was urged as a bar to inclusion of the trust corpus in his gross estate. The trust provided that in the event of a trustee's incapacity, the co-trustee could act alone and she in fact did so act. Decedent

The Second Circuit, under the compulsion of the contingent power test, has held that a power of invasion is not taxable where ". . . the trustees were not free to use their untrammelled discretion but were to be governed by determinable standards . . ."<sup>186</sup> but has imposed a tax where a settlor-trustee had a power to invade which the court considered exercisable ". . . in his absolute discretion. . . ."<sup>187</sup>

Under the state law of trusts an absolutely discretionary power cannot be granted to a trustee.<sup>188</sup> Hence, the immoderate language in the tax decisions must be discounted. Presumably, both the First and Second Circuit would agree with the Tax Court that a trustee must act in good faith in exercising any discretionary power to invade corpus but that this limitation on his discretion does not prevent a power from being taxable.<sup>189</sup> When these courts refer to a definite, adequate, or determinable external standard in the trust instrument governing the settlor-trustee's exercise of his power and, hence, making it not taxable,

had never been adjudged incompetent nor had he been removed as trustee. The Tax Court considered the latter fact grounds for imposition of a tax. "While the matter is one of first impression, we should think that some definite action might well be necessary to terminate the retained power of the decedent before the purpose of the statute can be defeated. It is not unusual that during a protracted illness one might be incapable, both physically and mentally, of making normal decisions affecting property rights, and yet we would not suppose that the statute did not apply in such cases." 6 T.C. at 823. On appeal, the question was posed as to "whether or not it is necessary as a matter of law that the decedent should have resigned, or been removed, in order to divest himself of the powers reserved in the instrument." The executrix relied on the state law rule that acts performed by a person who is in fact incompetent, though not having been so adjudged in legal proceedings, are not legally effective. But the First Circuit held that this rule was not controlling in the application of the tax statute. "The statute is not concerned with the *manner* in which the power is exercised, but rather with the existence of the power. The decedent may have been limited in his method by his incapacity, but it is not open to question that the power existed in his behalf, either by the trust instrument itself, or by the general law of Massachusetts; and he could have been removed." 160 F. 2d at 613. The court was here referring to the fact that the trust instrument provided that a co-trustee could act on behalf of an incapacitated trustee. But the general state law rule is that co-trustees must unite in the exercise of powers conferred upon them unless the trust instrument provides otherwise. RESTATEMENT (SECOND), TRUSTS §194 (1959). The court may have been referring to the possibility of a co-trustee subsequently ratifying acts performed by the other co-trustee. *Id.*, comment *c*.

<sup>186</sup> *Jennings v. Smith*, 161 F. 2d 74, 77 (1947), involving trusts wherein the settlor as co-trustee could invade corpus if the income beneficiary "should suffer prolonged illness or be overtaken by financial misfortune which the trustees deem extraordinary."

<sup>187</sup> *Mollenberg's Estate v. Comm'r*, 173 F. 2d 698, 701 (1949), involving a trust where the settlor-trustee was "authorized in his sole discretion to withdraw from the principal of the trust from time to time such sum or sums as he in his sole discretion may deem advisable and pay over the same to the aforesaid beneficiaries, or any of them, and the judgment of the Trustee with respect thereto shall be binding and conclusive on all parties interested therein."

<sup>188</sup> RESTATEMENT (SECOND), TRUSTS §187, comment *k* (1959).

<sup>189</sup> See note 179 *supra*. In *Jennings v. Smith*, the Second Circuit quoted from one of its earlier opinions wherein it had stated that ". . . no language, however strong, will entirely remove any power held in trust from the reach of a court of equity." 161 F. 2d at 77.

this appears to be comparable to the state law rule that a measurable standard enables a court to review the reasonableness of the trustee's conduct. But the Sixth Circuit has held that, although a settlor-trustee retains a tax-free power of invasion when it is limited by a determinable external standard enforceable in a state court, the adequacy of any external standard for tax purposes is a federal question which a state court is powerless to decide.<sup>190</sup> In that case a settlor had declared himself trustee of trusts for each of his three minor children. Under each trust the settlor-trustee had

... the right in his absolute discretion to distribute in whole or in part, the Trust Property to the Beneficiary at any time and in such manner and amount as he may deem the situation to warrant, it being the intention of the Grantor that while under ordinary circumstances it is not the desire that the Beneficiary come into the ownership of the Trust Property until the happening of all the conditions heretofore provided in that connection, the Trustees shall nonetheless be free to distribute the Trust Property, or any part thereof, to the Beneficiary at any time or in any manner or amount, should what the Trustee deems a special emergency arise.<sup>191</sup>

The Commissioner having determined that the corpus of each trust was includible in the settlor's gross estate, his executor paid a deficiency under protest and then filed a refund claim. The following month a proceeding was started in a state court for construction of the trust instruments and the local Collector of Internal Revenue was joined as a party defendant. The latter successfully moved for his dismissal as a defendant under a federal statute providing in effect that a United States officer could not be sued in a state court without his consent.<sup>192</sup> After the hearing, the state court issued a decree providing:

... the power of invasion of the Trustee of each of the said Trusts, exercisable in favor of the life beneficiary of each of said Trusts, in case of a special emergency ... is a limited power, exercisable only in case of special emergency; and as such is measured by a definite external standard—to wit, a special emergency occurring to said life beneficiary; and as such the power is subject to the jurisdiction and control of this Court sitting as a Court of Chancery, and the exercise or non-exercise of such power is subject to the review by this Court as to whether such

<sup>190</sup> *Michigan Trust Company v. Kavanaugh*, 284 F. 2d 502 (1960), *aff'g*, 137 F. Supp. 52 (E.D. Mich. 1955).

<sup>191</sup> Prior provisions of each trust called for distribution of the assets the day after the beneficiary reached the age of 35, or upon the settlor's death, whichever event occurred last. If a child did not survive the settlor, the assets were to revert to the settlor. If a child survived the settlor but died before attaining the age of 35 there were various gifts over.

<sup>192</sup> Commentators have approved the Treasury's policy of refusing to become a party to tax-oriented state court litigation. Stephens & Freeland, *The Role of Local Law and Local Adjudications in Federal Tax Controversies*, 46 MINN. L. REV. 223, 250-251 (1961).

exercise or non-exercise is a reasonable act on the part of the Trustee;

. . . no special emergency has been shown by any of the beneficiaries in any year from 1931 to and including the present year.<sup>193</sup>

In the tax refund suit the executor then contended that the state court decree was binding on the federal district court, relying especially on *Comm'r v. Blair*.<sup>194</sup> In the *Blair* decision the issue was whether the income beneficiary of a trust was subject to income tax on the trust income after a purported assignment of his interest. The Supreme Court held that the validity of the assignment was a question of local law and the state court's decision on this matter was binding for federal tax purposes. But treating the assignment as valid, the Supreme Court found a federal question left as to whether the assignor was still taxable on the trust income. It would seem that the federal district court in the *Michigan Trust Company* case might have used a similar two-step analysis and held that the extent to which the settlor-trustee's exercise of his discretionary power of invasion was subject to judicial review was a matter of state law, the government apparently conceding that the state court proceedings were adversary. But whether such a power was then a power to change enjoyment subject to section 2038 was a federal question. That is, the fact that the settlor-trustee had to act reasonably in deciding whether or not a special emergency existed justifying invasion of the corpus would not necessarily preclude classification of the power as a taxable power to change the beneficiary's enjoyment of the trust assets subject to section 2038. Instead, the federal district court was unable to see any property rights involved in the state court's determination which, for example, would enable the income beneficiary through judicial proceedings to compel the settlor-trustee to invade corpus if he had previously unreasonably refused to do so. Hence, *Blair* was considered distinguishable since

. . . the question in the instant case is whether a statutory standard or criterion laid down by the Internal Revenue Code has been met and not whether a state court decision as to a property right is binding as was the situation in *Blair*. . . .

Defendant admits that a state court decision determining property rights as between contesting parties in an adversary proceeding is relevant in a tax case, but contends that such local decision is without force in purporting to decide the existence of a federal criterion in a tax case. In this respect, the court agrees with defendant and holds that the question here involved is whether a statutory standard laid down by the Internal Reve-

<sup>193</sup> 137 F. Supp. at 54-55. The three trusts having been created in 1931, the last part of the decree was presumably designed to support a finding that the settlor only had a contingent power which was not in existence at the date of his death.

<sup>194</sup> 300 U.S. 5 (1937).

nue Code has been met. This is a federal question which a state court is without power to decide.<sup>195</sup>

Surprisingly, this oversimplified approach to the problem was approved by the Sixth Circuit which merely repeated the maxim that: "... state law may control in taxing matters only when the federal taxing act, by express language or necessary implication, makes its operation dependent upon state law."<sup>196</sup> Yet in deciding the substantive issue of whether the trusts before it contained a determinable external standard, the Sixth Circuit repeatedly referred to the fact that such a standard is one enforceable by a state court.

Both litigants agree that if the donor retains a power to invade corpus, but the power is limited by a determinable external standard, enforceable in a court of equity, then the power is not a power to alter, amend or revoke. This rule was developed in *Jennings v. Smith*, . . . There, the power to invade corpus, if the beneficiary or his issue "suffer prolonged illness or be overtaken by financial misfortune which the trustees deem extraordinary," did not constitute a power to alter, amend or revoke. The standard, as a limitation on the power, was specific. Here there is no specificity but the exercise of the power is left to the unbridled discretion of the settlor. The alleged limitation furnished no guide as to what constituted "a special emergency."

In *Hurd* . . . there was, likewise, no specific direction as to an adequate external standard enforceable in equity where the limitation upon the power merely stated that "the circumstances so required. . . ."<sup>197</sup>

According to the Sixth Circuit, the settlor-trustee had an "unbridled discretion" in deciding whether or not to invade corpus even though a state court had previously held the exercise or non-exercise of the power was subject to judicial review as to the reasonableness of the settlor-trustee's decision. Yet a determinable external standard is one enforceable by a state court. Since the Sixth Circuit refuses to consult state law in this area, it is understandably vague as to the circumstances under which such enforcement would occur.

Hopefully, some other court may have the courage to take a closer look at the state law concerning judicial control over discretionary powers of invasion as a preliminary step to determining whether a particular settlor-trustee had sufficient freedom of decision to justify classifying his power as a power to change enjoyment subject to section 2038.

#### B. *Where a Settlor is Not a Trustee*

Under the state law of trusts a settlor can reverse under the terms

<sup>195</sup> 137 F. Supp. at 57.

<sup>196</sup> 284 F. 2d at 506. Although not cited, the Supreme Court laid down this rule in *Burnet v. Harmel*, note 56 *supra*.

<sup>197</sup> 284 F. 2d at 505.



of the trust both a power to remove an incumbent trustee<sup>198</sup> and to appoint a successor trustee.<sup>199</sup> Presumably, both types of reserved powers could be classified as fiduciary powers held for the benefit of others rather than solely for the benefit of the settlor, at least where the settlor is not the sole beneficiary of the trust.<sup>200</sup> Hence, the settlor's decision to exercise such powers should be subject to judicial review. Where the settlor has reserved an unrestricted power to change trustees, it appears that he need not show cause for removing the present trustee, but a state court would intervene here if such action would injure the trust beneficiaries.<sup>201</sup>

In *Estate of Paul Loughridge*<sup>201</sup> the settlor had created a trust wherein he had a right to change trustees.

The Trustee, upon written notice from Paul Loughridge, shall . . . resign as Trustee hereunder; such resignation shall become effective on the day specified in the notice . . . which shall be not less than thirty days subsequent to the delivery of such notice to the Trustee. . . .

In case of the resignation of the Trustee, said Paul Loughridge . . . may, by an instrument in writing duly executed and acknowledged, appoint a successor trustee, and upon such appointment such trustee shall have all the rights and powers, discretionary or otherwise, which are herein given to the Trustee.<sup>203</sup>

One of the powers granted to the corporate trustee was a power to terminate the trust "at any time . . . it shall, in its absolute discretion, determine that it is for the best interest of the beneficiary." The Commissioner contended that, since the settlor had at the time of his death a power to become trustee and in that capacity could terminate the trust, the trust corpus was includible in the decedent's gross estate under the predecessor of section 2038. The Tax Court agreed.

While the decedent was not trustee at the date of his death, nevertheless, except for the fact that there could be no assurance of securing the resignation of the trustee until not less than thirty days after the delivery to him of a notice requiring such resignation, the decedent had the full power at the date of his death to require the resignation of the trustee, to name himself as successor

<sup>198</sup> RESTATEMENT (SECOND), TRUSTS §107, comment *h* (1959).

<sup>199</sup> *Id.*, §108(b); *Bowditch v. Bannuelos*, 67 Mass. 220 (1854).

<sup>200</sup> See text preceding note 30 *supra*.

<sup>201</sup> See *In re Lowe's Estate*, 68 Utah 49, 249 Pac. 128 (1926), where one of the beneficiaries of a testamentary trustee was given an unrestricted power to change trustees. On the state law generally, see BOGERT, TRUSTS AND TRUSTEES §520 (2d ed. 1960); NOSSMAN, TRUST ADMINISTRATION AND TAXATION §26.09 (rev. ed. 1956); SCOTT, TRUSTS, §§107.2 and 108.3 (2d ed. 1956).

<sup>202</sup> 11 T.C. 968, 973 (1948).

<sup>203</sup> *Id.* at 972. The latter phraseology eliminated any question under state law as to whether a successor trustee could exercise any discretionary powers conferred upon the original trustee. See RESTATEMENT (SECOND), TRUSTS §196, comment *d* (1959).

trustee, and then to immediately alter the trust . . . through termination thereof.<sup>204</sup>

On appeal, the executrix urged that under government state law the decedent did not have the power to name himself as successor trustee, citing New York cases in support of her contention. The majority opinion of the Twelfth Circuit dismissed them with the statement that ". . . none of them dealt even remotely with taxation and they are not in point."<sup>205</sup> The executrix also cited a later Tax Court decision where the settlor had reserved a power to change trustees but the Tax Court doubted that he could have named himself trustee because the instrument provided that the settlor, "expressly surrenders all right and power to amend, modify, or revoke this trust in whole or in part and expressly relinquishes all right, title, and interest in and to the subject matter of this trust and by the execution of this instrument does divest himself of any and all incidents of ownership."<sup>206</sup> The Tenth Circuit distinguished this decision since there the settlor was not one of the original trustees whereas in *Loughridge* he had been and resigned.

Appointing himself as one of the first trustees indicates persuasively that the decedent did not intend to surrender the right to appoint himself successor trustee at a later juncture in the trust period if the occasion to appoint a successor trustee should arise. In the absence of controlling statute or well established rule of local law otherwise, we perceive no tenable basis for the view that a settlor of a trust may appoint himself as the original trustee but may not name himself as successor trustee.<sup>207</sup>

The holding of the *Loughridge* case has been extended to a situation where the power of termination was not held by the trustees but by third parties in a fiduciary capacity.<sup>208</sup> But in that case it was contended that since the trust could only be terminated in favor of the settlor during her lifetime, under New York law either as trustee or as a person holding a power of termination in a fiduciary capacity she could not

<sup>204</sup> 11 T.C. at 978. The required period of notice was considered immaterial under the predecessor of §2038(b).

<sup>205</sup> A dissenting opinion doubted that under New York law the settlor could have appointed himself successor trustee since he then ". . . would receive commissions and other personal benefits. . . ." *Id.* at 306. It is doubtful if this, per se, could be considered sufficiently harmful to the trust beneficiaries. In any event, such objection was distinguished in *Van Beuren v. McLoughlin*, 262 F. 2d 315 (1st Cir. 1958), by a finding that the settlor could have directed a successor trustee to serve without compensation. But the Sixth Circuit also concluded: "In the absence of any indication to the contrary, we must hold that New York would follow the generally accepted rule that the settlor may make herself a trustee." *Id.* at 321. Here the court cited RESTATEMENT, TRUSTS §100 (1955), which provides that a settlor can be a trustee. The comment material, however, seems to refer to him becoming a trustee when the trust is initially created.

<sup>206</sup> *Estate of C. Dudley Wilson*, 13 T.C. 869 (1949), *aff'd per curiam*, 187 F. 2d 144 (3rd Cir. 1951).

<sup>207</sup> *Loughridge's Estate v. Comm'r*, 183 F. 2d 294, 301 (1950), *cert. denied* 340 U.S. 830 (1950).

<sup>208</sup> *Clark v. United States*, 267 F. 2d 501 (1st Cir. 1959).

terminate the trust in favor of herself. This problem was resolved by finding that had the settlor appointed herself holder of the power of termination, since it could only be exercised in favor of herself during her lifetime, she would have held a beneficial power rather than a power in trust under New York law.<sup>209</sup>

Where the settlor has reserved the power to appoint a successor trustee but not a power to remove the incumbent trustee, the doctrine of the *Loughridge* case has not been applied where at the settlor's death there was no vacancy which she could fill. Thus, in *Winchell v. United States*<sup>210</sup> the trust provided:

The trustee may resign at any time or apply to any proper court for the settlement of its accounts and to be relieved and discharged from this trust. . . . If, during the lifetime of the Grantor, the trustee should resign or cease to act, the Grantor shall have the right, which is hereby reserved to her, to appoint a successor.

The court held that

. . . the trust . . . did not give the grantor the unrestricted right to make herself trustee. Only if the trustee should "resign or cease to act" could the grantor appoint a successor. At the time of decedent's death the corporate trustee had neither resigned nor ceased to act. The limited conditions under which the decedent might have made herself trustee did not in fact exist at the time of her death. Consequently, . . . the grantor is not considered as having the powers of the trustee at the time of her death.<sup>211</sup>

Likewise, where the trustee does not have an express power to terminate the trust but only a power of invasion, the settlor's power to substitute himself as trustee does not result in inclusion of the assets in his gross estate if the power of invasion is governed by an adequate external standard. In *Estate of C. Dudley Wilson*<sup>212</sup> the trustee could "in his absolute discretion accelerate payments of . . . principal in case of need for the educational purposes or because of illness or for any other good reason." The Tax Court held:

The power of the trustee to accelerate payments of . . . principal was not unrestricted. There first had to be "need for educational purposes or because of illness or for any other good reason." Any action by the trustee would be subject to regulation by a court to make sure that he acted within sound and honest discretion granted him so that distributions would not depend upon the mere whim of the trustee and they could not be made to de-

<sup>209</sup> *Clark v. United States*, note 32 *supra*.

<sup>210</sup> 180 F. Supp. 710 (S.D. Calif. 1960), *aff'd*, 289 F. 2d 212 (9th Cir. 1961).

<sup>211</sup> 180 F. Supp. at 714 The court considered this result consistent with Treas. Reg. §20.2038-1(a): "But, for example, if the decedent had the unrestricted power to remove or discharge a trustee at any time and appoint himself trustee, the decedent is considered as having the powers of the trustee. However, this result would not follow if he only had the power to appoint himself trustee under limited conditions which did not exist at the time of his death."

<sup>212</sup> Note 205 *supra*.

feat the purpose of the trust. . . . Thus, if the decedent could have made himself trustee, he could not have distributed all of the corpus of the trusts to the beneficiaries unless some condition beyond his control justifying the distribution had arisen.<sup>213</sup>

The Tax Court distinguished the *Loughridge* case as one where the trustee's discretion to distribute was not ". . . limited by an adequate external standard, whereas here there was the standard of 'need for educational purposes or because of illness or for any other good reason.' The words 'in case of need' were intended to apply to the remainder of the sentence."<sup>214</sup>

Under state law, of course, a settlor may name himself as a beneficiary of a trust he creates.<sup>215</sup> In such situations, section 2036 would apply if the settlor retained the right to the trust income for life unless the trust were created prior to March 4, 1931.<sup>216</sup> Hence, section 2038 is important only as to trusts created prior to that time or where the settlor's retained beneficial interest is for some other reason beyond the scope of section 2036.<sup>217</sup>

In *Estate of Norma P. Durant*<sup>218</sup> a settlor had in 1926 and 1928 transferred virtually her entire estate to a corporate trustee under a trust wherein she reserved the right to receive \$1,250 a month which, since the assets were unlikely to produce this much income, was to be made up out of corpus if the income was insufficient. In addition, if this monthly payment was

. . . insufficient in the judgment of said Trustee to properly provide for the comfort, maintenance, and enjoyment of life by said Norma P. Durant, . . . said sum to be paid monthly to her [was to] be increased to such sum as in the opinion and judgment of said Trustee is proper.

Said Trustee shall have the right and power to pay to said Norma P. Durant, in addition to the monthly provision for maintenance, etc. any further sum or sums of money for the purpose of traveling, or purchasing a home, or other real estate solely however for her own use and enjoyment, and said Trustee may further pay to said Norma P. Durant, moneys for other purposes, which in the opinion and judgment of said Trustee it may be advisable to pay her in view of all the existing conditions and circumstances.<sup>219</sup>

<sup>213</sup> 13 T.C. at 872. Apparently, in trying to come within the rule of the *Loughridge* case, which involved an express power of termination, the Commissioner had contended that the settlor, upon substituting himself as trustee, could have terminated the trust, instead of merely contending that the settlor could have altered enjoyment of the trust assets by the beneficiaries.

<sup>214</sup> *Id.* at 211-212.

<sup>215</sup> RESTATEMENT (SECOND), TRUSTS §114 (1959).

<sup>216</sup> Treas. Reg. §20.2036-1(a). On the historical background of this section, see LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES §8.1-8.4 (2d ed. 1962).

<sup>217</sup> On the scope of §2036, particularly where there is a power to invade corpus, see LOWNDES & KRAMER, *op. cit. supra*, §8.19.

<sup>218</sup> 41 B.T.A. 462 (1940).

<sup>219</sup> *Id.* at 463.

The trust also provided that at the settlor's death the trustee should "ascertain and pay all of the just debts of said Norma P. Durant." Prior to her death the settlor had received from the trustee approximately half of the corpus. This apparently influenced the Board in finding that in reality the settlor retained until her death powers in herself alone or at least in conjunction with the trustee which were subject to the predecessor of section 2038.

The stipulated monthly payments were obviously materially in excess of any anticipated income from the property. It resulted, and must have been contemplated, that periodic invasions of principal would be necessary. Only decedent's refusal to accept such fragmentary distributions of principal could prevent the estate from being dissipated in its entirety. In fact, in the period of less than ten years of the trust's operation approximately 50 percent of the principal was so disbursed. At the same rate it would not have lasted for ten years more. Again, the primary obligation of the trustee upon decedent's death was to pay all of her debts, so that by the simple expedient of obtaining by loans or advances such amounts of principal as she might see fit she could effectively prevent all or any part of the property from passing to the remaindermen.<sup>220</sup>

But where the settlor had only received income from the trust, the trustee had never exercised his discretionary power to invade corpus for the settlor's benefit, and the trustee was under no express obligation to pay debts contracted by the settlor during his lifetime, the Tax Court summarily refused to find that the settlor had at his death a power subject to the predecessor of section 2038<sup>221</sup> and the Commissioner abandoned this contention on his appeal from another portion of the decision.<sup>222</sup>

In a later case the Tax Court suggested in a dictum that while section 2038 could not apply where the trustee had a discretionary power to invade corpus for the benefit of the settlor and there was no external standard governing the exercise of the trustee's discretion, since the settlor had no enforceable right to have the corpus invaded during his lifetime, the reverse should be true where the exercise of the trustee's discretion was subject to a clear standard.<sup>223</sup>

(To be continued in the next issue)

<sup>220</sup> *Id.* at 465.

<sup>221</sup> *Hugh M. Beugler Trust*, 2 T.C. 1052 (1943).

<sup>222</sup> *Sub. Nom. Comm'r v. Irving Trust Co.*, 147 F. 2d 946 (2d Cir. 1945).

<sup>223</sup> *Estate of Milton J. Budlong*, *supra* note 180, at 762. The court actually relied on cases using a transfer taking effect at death test. The suggested approach, of course, is the opposite of that used where the settlor is the trustee rather than the beneficiary.

On the possibility of extending the estate tax generally to trusts where the trustee has broad discretionary powers, see Lowndes, *Some Doubts About the Use of Trusts to Avoid the Estate Tax*, 47 MINN. L. REV. 31 (1962).